more

Annual Report 2003

more...

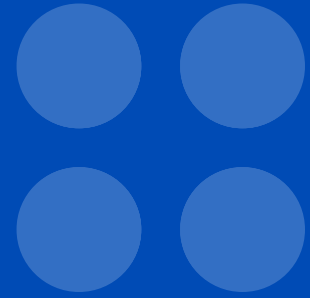
innovation

Year after year, Mega Bloks creates award-winning toys, captivating displays and exciting promotions.

We continually push the limits of excellence for the benefit of retailers and consumers.

More ideas. More passion. More innovation.

more...



fun

Mega Bloks offers a great toy assortment, from large building blocks for small hands to the most intricate construction sets for creative minds.

Our brand's action-packed adventure systems and growing cast of imaginary characters stimulate endless play, discovery and learning.

More play patterns. More characters. More fun.

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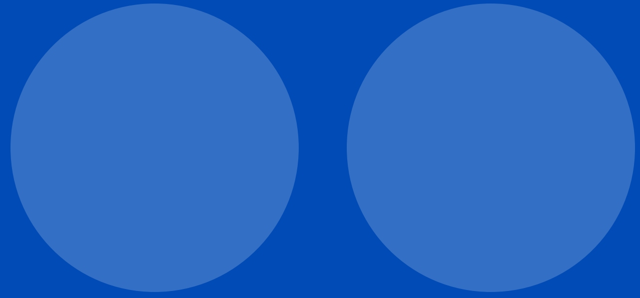
more...



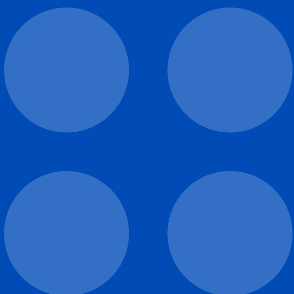
value

Mega Bloks is focused on the success of its customers.

We build quality toys
and back our products with a lifetime guarantee.

Our investments in the best processes and people
allow us to improve every day.

More speed. More efficiency. More value.



MEGA
BLOKS

MEGA
BLOKS

more...

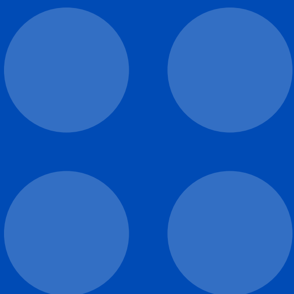
growth

Eighteen consecutive years of sales growth and the MEGA BLOKS brand is stronger than ever.

Last year, over 30 million children worldwide enjoyed our toys.

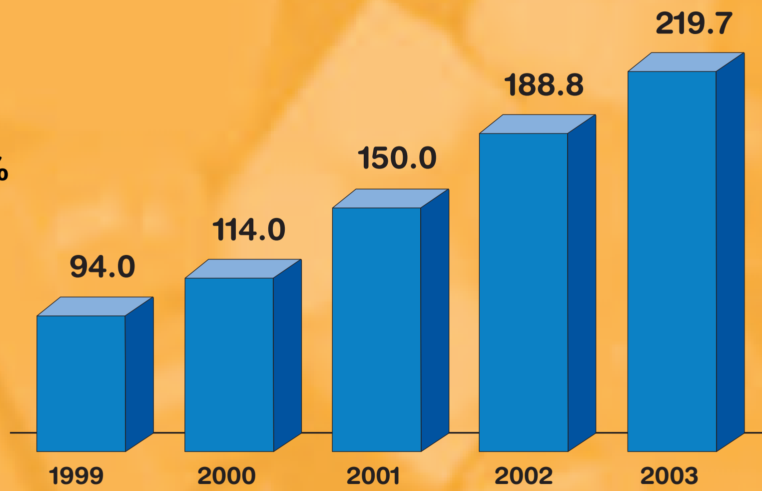
This universal appeal is the foundation of our global growth strategy.

More toys. More markets. More growth.



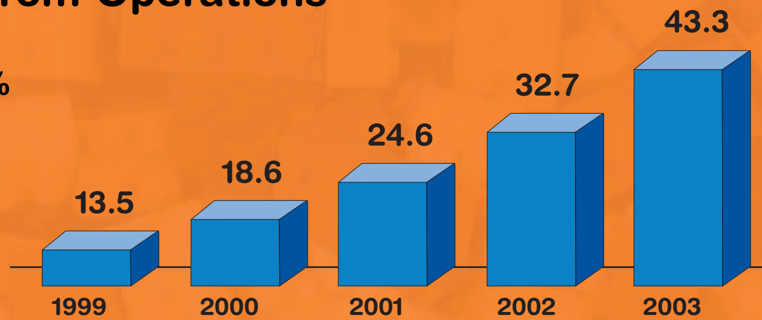
Net Sales
(US $ Millions)

CAGR*: 23.7%



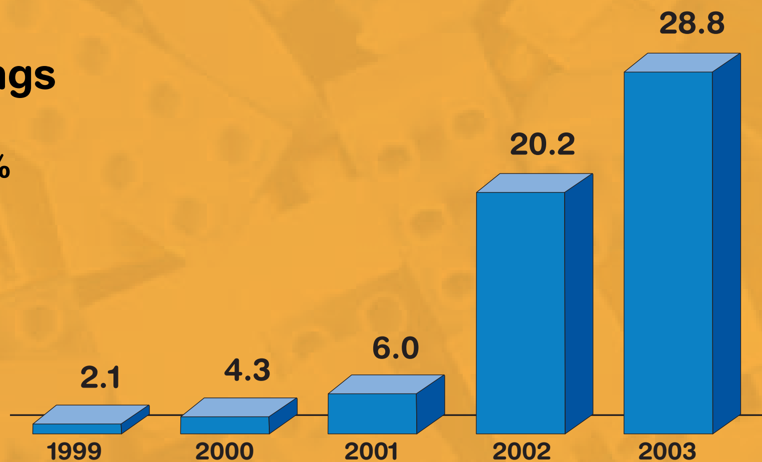
Earnings from Operations
(US $ Millions)

CAGR*: 33.8%



Net Earnings
(US $ Millions)

CAGR*: 92.9%



*Compounded annual growth rate

MEGA BLOKS
0-5
5+
more...

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Chairman's letter

Dear Shareholders,

It was another great year for Mega Bloks!

In 2003, our toys continued to win accolades, with a harvest of nearly 50 consumer and trade awards, the most for us in a single year. Mega Bloks was named "Canadian Exporter of the Year" in addition to winning its own category in the Canada Export Awards, and the Company's two top executives received the Ernst & Young "Entrepreneur of the Year" award. Our financial performance was solid, with an 18th consecutive year of sales growth and record net earnings.

These results stem directly from a sound business strategy and solid execution by the members of our organization. Both the strategy and the execution are driven by strong leadership from the senior management team – a group with a wealth of experience in the toy industry and related fields.

Working closely with management, the Board of Directors plays an important role in the Company's success. For this reason, upon becoming a public company in 2002, our primary objective was to build a Board to meet the needs of the business and to satisfy increasingly demanding regulatory requirements.

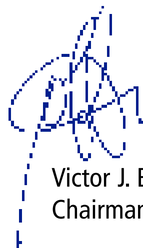
We appointed three distinguished business people – Jean-Guy Desjardins, Michel Coutu and Peter T. Main – to the Board in 2002. Recently, they were joined by Paula Rozicki-Howell, an accomplished figure in the Canadian advertising industry.

Together with David I. Foley, an executive of the The Blackstone Group who has accepted our invitation to remain on the Board, they form a solid core group of independent directors with the requisite business experience and specific knowledge to support the Company's growth. As representatives of all shareholders, they will also provide oversight in the course of the Board's deliberations and by exercising their responsibilities as members of our audit, governance and compensation committees. Each of these committees is composed entirely of independent directors.

We wish to thank Howard A. Lipson and Anjan Mukherjee, two Blackstone executives who have stepped down as directors, for their contribution to the Company's success.

Once again in 2003, our people demonstrated tremendous innovation and dedication. Mega Bloks reached new heights because of their efforts. They deserve our sincere congratulations and thanks for a job well done.

Yours very truly,



Victor J. Bertrand
Chairman of the Board

more

Message to shareholders

For Mega Bloks, 2003 was another record year. We led the construction toy category in sales growth and outperformed the overall industry. In all of our markets, we continued to expand the MEGA BLOKS brand and create new opportunities for sustained profitable growth.

More performance

Our sales increased 16% in 2003 to $219.7 million compared to $188.8 million in 2002, marking the 18th consecutive year of growth. Net earnings were up 43% to $28.8 million, reaching a new high, compared to $20.2 million in the previous year, for diluted earnings per share of $0.98 and $0.76, respectively.

In North America, our sales grew 4% in 2003 despite the cautious inventory approach of customers. More significantly, consumer takeaway of MEGA BLOKS products at retail increased by 8-9% compared to 2002. International sales jumped 44% to $81.7 million, driven by the successful execution of our global expansion strategy.

Our solid financial performance, growth momentum in all markets and favorable inventory position at retail bode well for Mega Bloks in 2004.

More growth

Our results demonstrate that Mega Bloks is positioned more strongly than ever for continued growth in the $40 billion global toy industry. We have a sound strategy, solid relationships with the world's leading retailers and experienced teams to execute our plans in every market.

In North America, the largest toy market, our performance at retail in 2003 was superior to that of the toy industry, which experienced a 3% decline in sales, and well ahead of the construction category. We are well positioned to achieve sales growth based on the strength of our brand, creative merchandising initiatives and expanded retail channels.

In Europe, we are beginning to capitalize on our local market strategy launched in 1999.

- The outstanding 2003 results in our key European markets were achieved because the MEGA BLOKS brand is now well established, with permanent shelf space that is growing.
- We have a major opportunity in Germany and certain neighboring markets where only our preschool line is currently marketed. We are working with determination to open these countries to our full product offering in the medium term.
- With most countries in Central and Eastern Europe entering the European Union this year, we see great potential for tapping these markets with our current retail partners as they open new stores.

We are the category leader in Mexico and are looking closely at increasing our position in Latin America, particularly in Brazil where economic stability is being restored.

Asia is a tremendous market for our products. In 2003, we took a significant step forward by entering Japan in partnership with Bandai, the country's leading toy manufacturer.

All of these opportunities add up to more growth.

Japan and Asia strategy launched

Mega Bloks penetrated Japan in 2003 in partnership with Bandai, the country's leading toy manufacturer. Over 30 jointly developed toys were available at retail by the fourth quarter of the year, setting the stage for a larger co-branded offering in 2004.

Japan is second only to the United States in terms of toy sales, and the construction category is a much smaller component of the overall market, representing a huge opportunity for Mega Bloks. Under the multi-year agreement, Mega Bloks and Bandai will cooperate in selected Asian countries and Mega Bloks plans to distribute certain jointly developed products in North America, Europe and other world markets.

More value

By delivering more value, we are becoming a more important partner for retailers. Our reward is expanded shelf space worldwide, and a greater opportunity to display our toys in increasingly imaginative ways to reach more consumers. What do retailers want? Toys that sell quickly, have high fill rates and healthy gross margins. Consumers measure value in terms of affordability and how well toys entertain, stimulate and educate.

Mega Bloks delivers more value to retailers and consumers through our ongoing commitment to innovation, R&D and vertical integration. Our team of professionals that drives the creative and engineering processes essential to making great toys has grown to 120 talented people. We invest continuously in the latest design and prototyping technologies to accelerate new product development.

In manufacturing, we achieve the highest efficiency by benchmarking every product on the basis of best cost between our Canadian plant and overseas suppliers. Our Montreal facility is equipped with the latest technology to optimize productivity while achieving high quality and quick production turnaround. It is complemented by outsourced production in Asia of labor-intensive products with electronics, intricate decoration or other special effects. This is our winning combination for speed and value.

Tapping licensing opportunities

With licensing representing 25% of the U.S. toy industry, Mega Bloks is focused on capturing incremental growth by complementing original product lines with new themes based on stable properties with lasting appeal. In 2002, we signed a multi-year agreement with Disney and in 2003 we successfully launched products featuring Winnie the Pooh, Princess and Power Rangers.

For our 2004 product line-up, we are introducing toys based on new licenses with NASCAR and Teenage Mutant Ninja Turtles, while continuing to leverage our association with Disney.

More fun

Mega Bloks is in the business of entertaining children and stimulating their development with our building blocks that are fun and educational. Our characters add entertainment and play value while enriching the learning experience, and we keep adding new heroes and heroines to our collection. Through the years, we have created original favorites such as Block Buddies and Dragons, complemented by evergreen licensed characters.

Among global toy brands, very few have been able to establish the wide age reach of our product lines. MEGA BLOKS preschool, which appeals to boys and girls under five years of age, is the leader in the construction category. Micro MEGA BLOKS is a growing force in the boys 5+ segment with an expanding selection of play sets, characters and themes featuring hybrid design. Boys will be very excited with our new Nano Building System being launched in the second half of 2004.

Every toy we sell is branded MEGA BLOKS. In 2003, almost 30 million MEGA BLOKS units were sold worldwide, making as many impressions with children and their parents everywhere. We build more fun into every toy because that is what children really want.

Feature movie breaks new ground

The magic of movie storytelling is being used for the first time to extend the reach of the MEGA BLOKS brand. A feature film now under production will bring the highly popular Dragons universe to life, unlocking the world of mythology, warriors and savage creatures embodied in this Mega Bloks property.

The animation adventure called "Dragons: Fire and Ice", will be launched in Fall 2004 as a movie of the week special in the United States and Canada, and then released on DVD in North America. The International release of the film is scheduled for 2005.

more

More innovation

In 2004, we are launching more than 50 new products, giving us the broadest and most exciting toy line-up ever. Retailer feedback at recent toy fairs has been extremely positive, demonstrating once again that Mega Bloks leads innovation in the construction toy category.

Captivating new themes, imaginative line extensions and refreshed favorites promise to inject new vitality into our brand for 2004. And we continue to add new play patterns and licensed characters that stretch the category and broaden the appeal of our products.

Product innovation is only the starting point. At retail, we bring toys to life through fascinating displays that build brand awareness and draw children and adults to the toy section. Attractive and practical packaging, visually appealing planograms and efficient shelf arrangements all contribute to the consumer shopping experience and the productivity of our shelf space.

The third pillar of innovation at Mega Bloks is the way we promote our brand worldwide. We are continually adding to our mix of promotional activities and advertising, both print and television, to achieve the highest impact at the best cost. For 2004, we are adding a completely new dimension with the planned release of a feature film, "Dragons: Fire and Ice". This television and direct to video movie will bring our popular Dragons line to a new engaging level of interaction with consumers.

People making the difference

Mega Bloks is a worldwide brand, supported by a motivated global organization. People drive performance and our management team sets the conditions that allow individuals to achieve their potential.

We are guided by a long-term strategy, clear objectives and detailed action plans. Our focus is on creativity and results – every day. Our enthusiastic, dedicated and hard-working teams pull in the same direction in an atmosphere of mutual respect. We share pride in making the best toys in the world. This common culture is one of our most important strengths.

We congratulate our employees for another record year in 2003 and thank them for their commitment to our mission.

Setting our sights higher

By always delivering more in the critical areas of our business, we are continually expanding the reach and value of the MEGA BLOKS brand worldwide. Every year, retailers and consumers demand more, and we respond by setting our sights higher.

We are positioned better than ever to leverage the growing strength of our brand and our strong relationships with global retailers. With the best product line-up in our history, we are confident that 2004 will be another record year for Mega Bloks.

Marc Bertrand
President and Chief Executive Officer

Vic Bertrand
Executive Vice President and Chief Operating Officer

Management's Discussion and Analysis

This management's discussion and analysis of financial position and results of operations ("MD&A"), dated March 24, 2004, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the years ended December 31, 2003 and 2002. All figures in this MD&A are expressed in U.S. dollars, unless otherwise indicated.

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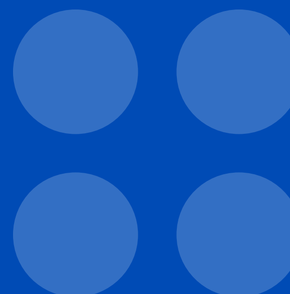

Corporate overview

Mega Bloks Inc. ("Mega Bloks" or the "Company") is the world's second largest manufacturer and marketer of construction toys and the largest Canadian toy company. The Company designs, manufactures and markets a broad line of construction toys under the MEGA BLOKS brand, targeting the preschool and age 5+ markets. Over 90% of its products retail for $29.99 or less. Based on the enduring play value of the Company's system of interlocking plastic building blocks, its products have broad appeal and enjoy relatively steady demand.

The Company and its wholly-owned subsidiaries employ more than 1,000 people serving over 100 countries from 11 offices around the world. The Company expanded its market reach outside North America by establishing Mega Bloks Latinoamerica S.A de C.V. in 1997 and Mega Bloks Europe N.V. in 1998. These subsidiaries directly support major international retailers while providing a logistical and administrative platform for the Company's global operations. The Company markets and distributes its products primarily through its own network in nearly all major toy markets. In 2003, 63% of consolidated net sales were recorded in North America, which is comprised of the United States and Canada, and the balance in the International market, which includes sales in all other countries.

The Company operates a state-of-the-art manufacturing facility in Montreal, featuring multiple capacity plastic injection-molding machines, specialized automated counting systems and multi-product integrated assembly lines. Toys manufactured in this facility accounted for approximately 65% of 2003 sales and the remaining sales were derived from products manufactured under contract in Asia.

The Company successfully closed its initial public offering ("IPO") in 2002 and listed its shares on the Toronto Stock Exchange. The Company issued 7,250,000 common shares from treasury at a price of CA$14.50 per share, resulting in gross proceeds of CA$105.1 million. Concurrent with the IPO, the Company entered into a new credit facility totalling $75.0 million with a syndicate of lenders. The Company used the net proceeds of its IPO and new credit facility to repay all outstanding indebtedness under its previous credit facility.

Corporate developments in 2003

At the end of the first quarter, the Company repaid the remaining balance of $13.5 million and terminated its Term A credit facility. Concurrently, its revolving credit facility was increased to $45.0 million from $35.0 million to support its ongoing growth initiatives.

During the second quarter, the Company announced a multi-year joint development and distribution agreement with Bandai Co., Ltd. ("Bandai"), the leading toy manufacturer in Japan. The first jointly developed products for the Japanese market, co-branded MEGA BLOKS and BANDAI, were in retail by the end of the third quarter of 2003.

Also during the second quarter, The Blackstone Group sold substantially all of their remaining equity position in the Company in a secondary offering. The Company did not issue common shares in this offering and did not receive any proceeds.

During the third quarter, the Company entered into a global agreement for the right to manufacture and market the all-new Teenage Mutant Ninja Turtles, re-launched in 2003 through an animated television series on Fox Box in the United States and Teletoon in Canada. This agreement is in line with the Company's strategy of licensing entertainment properties having lasting appeal that can incrementally contribute to the growth of its brand.

Also in the third quarter, the Federal Court of Appeal of Canada released a decision dismissing, with costs, the appeal filed by Kirkbi AG and Lego Canada Inc. (collectively referred to as "LEGO") from the May 2002 decision of the Federal Court Trial Division. Through this action, LEGO claimed exclusive rights in the "look" of the knobs on its standard LEGO brick and alleged that the manufacture and sale of the Company's Micro MEGA BLOKS construction blocks constituted passing off pursuant to the Trade-marks Act of Canada. LEGO has filed a request for leave to appeal to the Supreme Court of Canada. A ruling is expected in the first half of 2004.

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Selected financial information

The following table presents a summary of selected consolidated income statement data for the years ended December 31, 2003, 2002 and 2001, as well as the three-month periods ended December 31, 2003 and 2002:

	Years ended December 31,			Three-month periods ended December 31,	
(US $ thousands, except per share data)	**2003**	2002	2001	**2003**	2002
Earnings Data					
Net sales	**$219,691**	$ 188,807	$ 150,043	**$ 92,094**	$ 80,876
Cost of sales	**117,244**	98,816	80,021	**49,542**	41,139
Gross profit	**102,447**	89,991	70,022	**42,552**	39,737
Marketing, research and development and advertising expenses	**28,161**	21,701	16,502	**10,659**	8,375
Other selling, distribution and administrative expenses	**35,298**	30,047	23,623	**11,211**	9,402
(Gain) loss on foreign currency translation	**(4,284)**	(223)	1,609	**(1,557)**	(198)
Unusual items	**–**	5,816	3,716	**–**	–
Earnings from operations	**43,272**	32,650	24,572	**22,239**	22,158
Interest expense	**1,802**	4,856	10,348	**265**	1,254
Earnings before income taxes	**41,470**	27,794	14,224	**21,974**	20,904
Income taxes	**12,665**	7,628	8,176	**5,840**	7,176
Net earnings	**$ 28,805**	$ 20,166	$ 6,048	**$ 16,134**	$ 13,728
Per Share Data					
Earnings per share					
Basic	**$ 1.07**	$ 0.83	$ 0.31	**$ 0.59**	$ 0.51
Diluted	**0.98**	0.76	–	**0.55**	0.47
Weighted average number of outstanding shares					
Basic	**26,992,797**	24,261,617	19,273,020	**27,117,037**	26,838,838
Diluted	**29,437,062**	26,467,410	–	**29,557,515**	29,272,628

The following tables present a summary of selected consolidated balance sheet data and Canadian dollar data for the years ended December 31, 2003, 2002 and 2001:

	As at December 31,		
(US $ thousands)	**2003**	2002	2001
Balance Sheet Data			
Working capital[1]	**$ 86,179**	$ 61,221	$ 55,813
Capital assets	**33,510**	30,318	27,018
Total assets	**164,718**	123,694	106,519
Total debt	**36,444**	43,757	113,850

	Years ended December 31,		
(Canadian $ thousands, except per share data)	**2003**	2002	2001
Canadian Dollar Data[2]			
Net sales	**$283,929**	$ 244,014	$ 193,916
Earnings from operations	**55,925**	42,197	31,757
Net earnings	**37,228**	26,063	7,816
Earnings per share			
Basic	**$ 1.38**	$ 1.07	$ 0.41
Diluted	**1.26**	0.98	–

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

(2) U.S. dollar financial data is converted into Canadian dollars at the December 31, 2003 year end exchange rate of CA$1.2924 per US$1.00, using the translation of convenience method.

Contractual obligations

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

	Years						
(US $ thousands)	2004	2005	2006	2007	2008	After 5 years	Total
Long-term debt	302	250	250	10,125	23,750	–	34,677
Capital leases	653	292	295	351	176	–	1,767
Operating leases	3,533	3,657	3,660	3,835	3,904	10,086	28,675
Total contractual obligations	4,488	4,199	4,205	14,311	27,830	10,086	65,119

Year ended December 31, 2003 compared to year ended December 31, 2002

Net sales

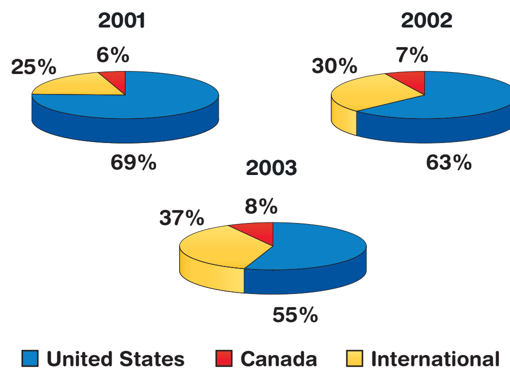
Net sales increased 16.4% to $219.7 million in 2003, compared to $188.8 million in 2002. Several factors contributed to this sales growth:

- Strong performance in all key European markets;
- Higher sales in North America despite a challenging retail environment for the toy industry;
- Successful introduction of the Company's co-branded product line in the Japanese market;
- Strong sales of new products, line extensions and enhanced existing toy lines.

Net sales in North America rose 4.4% to $138.0 million in 2003 compared to $132.2 million in 2002. Sales in the U.S. increased 2.3% to $121.4 million from $118.7 million in 2002, despite the cautious inventory approach of major retailers and an overall challenging environment for the toy industry. Sales in Canada rose 23.8% to $16.6 million in 2003.

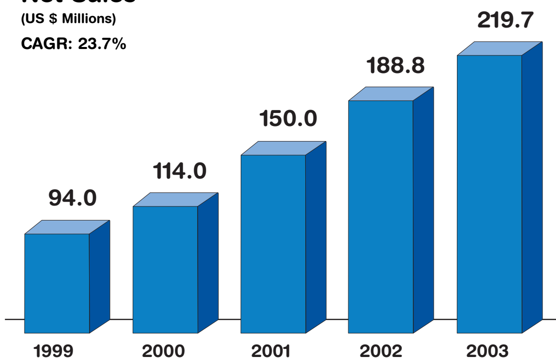
International net sales totalled $81.7 million in 2003, an increase of 44.1% compared to 2002. This strong increase was driven primarily by growth in all key European markets and positive sales results in Japan following the retail launch of our co-branded product line during the third quarter of 2003.

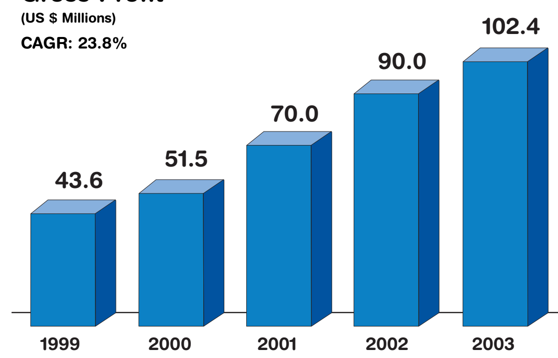
Reflecting the geographic sales growth experienced in 2003, International net sales accounted for 37.2% of consolidated net sales compared to 30.0% in 2002.



Gross profit

Gross profit in 2003 reached $102.4 million compared to $90.0 million in 2002, an increase of 13.8%. The increase in gross profit was driven by sales growth. As a percentage of net sales, gross profit was 46.6% in 2003 compared to 47.7% in 2002. The decline in gross profit percentage was mainly due to changes in product and customer mix compared to 2002, as well as the appreciation of the Canadian dollar against the U.S. dollar.





Operating expenses

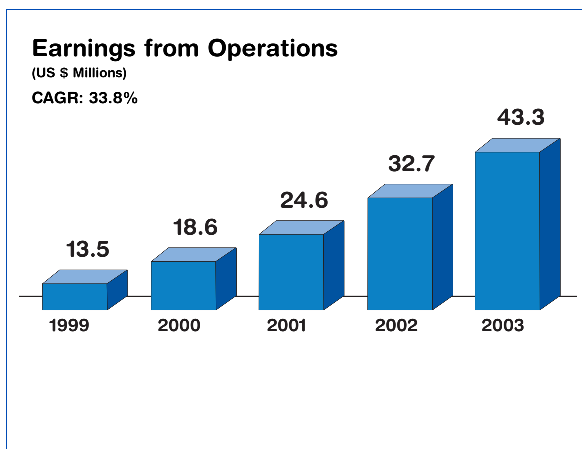
Marketing, research and development, and advertising expenses were $28.2 million in 2003 compared to $21.7 million in 2002, up 29.8%. As a percentage of net sales, such expenses were 12.8% in 2003 compared to 11.5% in the previous year. This reflects higher brand investment and additional research and development costs to support growing product introductions, including a focused effort in the second half of 2003 to penetrate the Japanese market.

Other selling, distribution and administrative expenses rose 17.5% to $35.3 million in 2003 compared to $30.0 million in 2002. Such expenses represented 16.1% of sales in 2003 compared to 15.9% in 2002. Approximately $1.1 million of the increase is related to the recording of a provision for bad debt in connection with the bankruptcy filing of a U.S. customer in January 2004. An additional $0.3 million reflects the expensing of stock options under new accounting guidelines adopted during the year. The new guidelines are mandatory in Canada commencing in 2004. The balance of the increase was mainly attributable to higher distribution costs in international markets, in line with sales growth.

The Company recorded a gain on foreign currency translation of $4.3 million in 2003 compared to a gain of $0.2 million in the previous year. The gain primarily reflects the maturity of foreign exchange contracts at favorable rates.

Earnings from operations

Earnings from operations increased 32.5% to $43.3 million in 2003 compared to $32.7 million in 2002.



Earnings from operations in 2003 does not include any unusual items. Such items totalled $5.8 million in 2002, consisting primarily of expenses directly related to the Company's IPO. Included in unusual items in 2002 were a $2.3 million one-time charge in connection with the cancellation of all loan commitments under its previous credit facility and a $2.6 million non-recurring charge for the recording of a liquidity event award accrual. An additional $0.7 million non-recurring charge was recorded for consulting and professional services rendered in relation to the settlement of a tax audit by the Canada Revenue Agency ("CRA").

Non-operating expenses

Interest expense was $1.8 million in 2003 compared to $4.9 million in 2002, reflecting mainly lower borrowing levels during 2003 and, to a lesser extent, lower average interest rates compared to the previous year.

Income tax expense was $12.7 million in 2003 compared to $7.6 million in 2002. Included in income taxes for 2002 is an adjustment of approximately $1.8 million relating to the reversal of a non-recurring tax provision recorded in 2001 in connection with the CRA's tax audit.

The effective tax rate was 30.5% in 2003 compared to 34.1% in 2002. This decrease reflects mainly a lower income tax expense in Canada in 2003 resulting from the appreciation of the Canadian dollar against the U.S. currency. Although the Company reports in U.S. dollars, it is required to use the Canadian dollar as its reporting currency for tax purposes in Canada. As a percentage of net sales, earnings before income taxes in Canadian dollars decreased significantly compared to 2002 as a result of the stronger Canadian dollar, therefore explaining the recording of a lower income tax expense in Canada. The Company's income tax expense on profit generated from International markets also declined in 2003 as a result of a tax restructuring plan initiated during the year.

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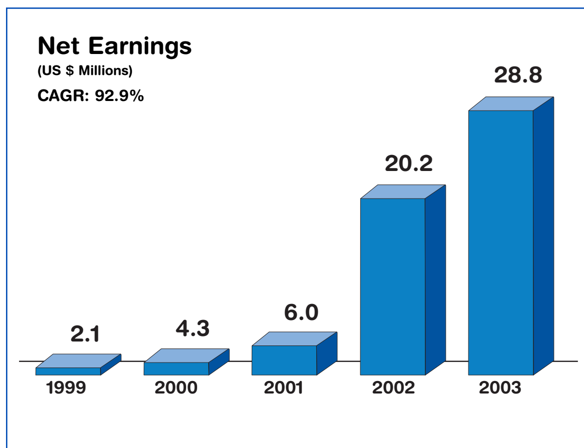
Net earnings

Net earnings increased 42.8% in 2003 to $28.8 million, or $0.98 diluted earnings per share, compared to $20.2 million, or $0.76 per share, in 2002.



Three-month period ended December 31, 2003 compared to three-month period ended December 31, 2002

Net sales

Net sales in the fourth quarter of 2003 increased 13.9% to $92.1 million compared to $80.9 million in the fourth quarter of 2002.

Reflecting tight inventory management by major retailers, North American net sales declined 2.4% during the quarter although the Company's products sold well at retail. International net sales were up 87.9% to $27.4 million in 2003.

Gross profit

Gross profit was $42.6 million in the 2003 quarter, compared to $39.7 million in the same period in 2002. Gross margin was 46.2%, compared to 49.1% in 2002. The decrease in gross margin is explained mainly by the strengthening of the Canadian dollar against the U.S. dollar and changes in product and customer mix.

Earnings from operations

Earnings from operations for both quarters totalled $22.2 million. This includes a gain on foreign currency translation of $1.6 million in 2003 compared to a gain of $0.2 million in the same period in 2002.

Net earnings

As a result of the above, net earnings were $16.1 million, or $0.55 diluted earnings per share, in the fourth quarter of 2003 compared to $13.7 million, or $0.47 per share, in the fourth quarter of 2002.

Cash flows

Cash flows generated from operating activities, after changes in non-cash operating working capital items, totalled $2.5 million in 2003 compared to $20.3 million in 2002. This decrease results mainly from an increase in accounts receivable and inventories as a result of shipments to customers occurring later in the fourth quarter of 2003 due to a strict inventory management program introduced by major retailers.

Year ended December 31, 2002 compared to year ended December 31, 2001

Net sales

Net sales in 2002 increased 25.8% to $188.8 million compared to $150.0 million in 2001. The Company achieved its overall growth through the:

- Introduction of new items in existing product lines;
- Successful introduction of new innovative product lines;
- Strong performance in all key international markets;
- Penetration of new retail channels;
- Expansion with the world's largest retailers by growing with them as they opened new stores and by capturing additional shelf space.

In North America, net sales grew 17.2% to $132.2 million in 2002 compared to $112.8 million in 2001. International net sales rose 52.0% to $56.6 million compared to $37.3 million in 2001. In 2002, International net sales represented 30.0% of total net sales compared to 24.8% in 2001.

Gross profit

Gross profit in 2002 totalled $90.0 million compared to $70.0 million in 2001, an increase of 28.5%. As a percentage of net sales, gross profit was 47.7% in 2002 compared to 46.7% in 2001. The increase in gross profit in 2002 was primarily due to greater sales of higher margin products and efficiency improvements in manufacturing, which fully offset rising raw material costs resulting from increasing crude oil prices.

Operating expenses

Marketing, research and development and advertising expenses increased 31.5% to $21.7 million in 2002 compared to $16.5 million in 2001. As a percentage of net sales, such expenses represented 11.5% in 2002 compared to 11.0% in 2001. In 2002, the Company increased its investment in the MEGA BLOKS brand through mass-market advertising, including television commercials and print advertisements. The Company also benefited from co-op advertising with its customers, which increased proportionately in 2002 in line with net sales. In addition, the Company continued to add to its research and development infrastructure, in order to maintain its leadership in the introduction of new products, which is critical in the toy industry.

Other selling, distribution and administrative expenses increased 27.2% in 2002 to $30.0 million compared to $23.6 million in 2001. As a percentage of net sales, such expenses represented 15.9% in 2002 compared to 15.7% in 2001. This nominal percentage increase was mainly due to higher distribution costs in international markets, sales team expansion and increased pricing for the Company's insurance programs, offset by the leveraging of general and administration costs.

Gain on foreign currency translation in 2002 was $0.2 million compared to a loss of $1.6 million in 2001, an improvement of approximately $1.8 million. The gain on foreign currency translation in 2002 was primarily due to the strengthening of the Euro in relation to the U.S. dollar.

Unusual items in 2002 amounted to $5.8 million compared to $3.7 million in 2001. In 2002, unusual items consisted primarily of expenses directly related to the Company's IPO, which included a $2.6 million non-recurring charge for the recording of a liquidity event award accrual, and a $2.3 million charge incurred in connection with the cancellation of all loan commitments under the Company's previous credit facility. In addition, the Company incurred a $0.7 million non-recurring charge for consulting and professional services rendered in connection with the settlement of the CRA tax audit. In 2001, unusual items of $3.7 million consisted primarily of a $1.7 million non-recurring charge for moving expenses related to the relocation of the Company's facilities and a $1.4 million charge incurred in connection with an amendment to the Company's previous credit facility completed in February 2001.

Earnings from operations

As a result of the above, earnings from operations in 2002 totalled $32.7 million compared to $24.6 million in 2001.

Non-operating expenses

Interest expense in 2002 was $4.9 million compared to $10.3 million in 2001. This decrease was mainly due to lower borrowing levels resulting from the successful closing of the IPO on May 9, 2002, and lower floating interest rates.

Income tax expense in 2002 was $7.6 million compared to $8.2 million in 2001. Included in the 2002 figure is an adjustment of approximately $1.8 million relating to the reversal of a $3.0 million non-recurring tax provision recorded in 2001 in connection with the CRA tax audit. Excluding the reversal of the non-recurring tax provision in 2002 and the corresponding set-up of the provision in 2001, the Company's effective income tax rate in 2002 decreased to 34.1% compared to 36.4% in 2001. The decrease reflects declining statutory tax rates.

Net earnings

Net earnings increased 233.4% in 2002 to $20.2 million, or $0.83 basic earnings per share, compared to $6.0 million, or $0.31 per share, in 2001. This increase reflects improved earnings from operations coupled with reduced interest and income tax expenses.

The higher basic earnings per share takes into account a 25.9% year-over-year increase in the weighted average number of shares outstanding. The weighted average number of shares increased primarily as a result of the issuance of shares as part of the Company's IPO in May 2002.

Shares outstanding

The weighted average number of shares outstanding in 2003 was 26,992,797 compared to 24,261,617 in 2002. The diluted weighted average number of shares outstanding in 2003 was 29,437,062 compared to 26,467,410 in 2002.

Seasonality and quarterly fluctuations

The toy business is seasonal and the Company has historically experienced significant quarterly fluctuations in operating results. 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. The Company's profitability is typically lower for the first and second quarters as a result of fairly constant fixed operating expenses while net sales are at their lowest levels of the year. This seasonality is consistent with the results of other companies in the toy industry and management anticipates this will continue in the future.

As a result of the seasonal nature of its business, the Company's interim statements of cash flows are generally not indicative of cash flows for a full year. Therefore, year-over-year comparisons between statements of cash flows are generally more meaningful than with the previous year-end.

The following table presents selected quarterly financial information for the years 2003 and 2002:

2003

	Q1	Q2	Q3	Q4
		(US $ thousands, except per share data)		
Net sales	22,651	26,580	78,366	92,094
As a % of full year	*10.3%*	*12.1%*	*35.7%*	*41.9%*
Gross profit	10,014	11,383	38,498	42,552
Earnings from operations	197	878	19,958	22,239
Net earnings (loss)	(220)	278	12,613	16,134
EPS Basic	(0.01)	0.01	0.47	0.59
EPS Diluted	–	0.01	0.43	0.55

2002

	Q1	Q2	Q3	Q4
		(US $ thousands, except per share data)		
Net sales	18,708	22,558	66,665	80,876
As a % of full year	*9.9%*	*11.9%*	*35.3%*	*42.8%*
Gross profit	8,247	9,483	32,524	39,737
Earnings from operations	(86)	(5,465)	16,043	22,158
Net earnings (loss)	(1,269)	(2,674)	10,381	13,728
EPS Basic	(0.06)	(0.11)	0.39	0.51
EPS Diluted	–	–	0.36	0.47

Liquidity and capital resources

The Company has historically funded its operations and capital requirements with cash generated from operations and borrowings under a revolving credit facility. The Company's 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 business, working capital requirements are variable throughout the year. The Company's need for working capital typically grows through the first three quarters as inventories are built up for the peak sales period in the fourth quarter.

Cash flows generated from operating activities, after changes in non-cash operating working capital items totalled $18.4 million in 2003 compared to $17.2 million in 2002. This slight increase results from higher earnings offset by an increase in non-cash working capital items, and more specifically, accounts receivables and inventories. Accounts receivable increased 34.3% in 2003 compared to 2002 as a result of shipments to customers occurring later in the fourth quarter of 2003 due to a strict inventory management program introduced by major retailers. For this reason, inventories at the end of 2003 increased 68.7% compared to 2002.

Cash flows used in financing activities were $8.0 million in 2003 compared to $11.9 million in 2002. During 2003, the Company repaid the remaining balance of $13.5 million and terminated its Term A credit facility. During 2002, financing activities generated approximately $101.5 million, principally through the issuance of capital stock in connection with the closing of the Company's IPO and the execution of a new credit facility with a syndicate of lenders. The borrowings under the new credit facility, together with the proceeds from the IPO, were used to repay all outstanding indebtedness under the previous credit facility.

Cash flows used in investing activities amounted $9.8 million in 2003 compared to $9.0 million in 2002. The Company invested $9.8 million in capital assets during 2003, primarily to support the introduction of new product line initiatives compared to $9.1 million in 2002.

Anticipated sales growth in 2004 will result in increased working capital requirements mainly to finance trade accounts receivable and inventories. The Company will continue to fund its operations and working capital requirements with cash generated from operations and borrowings from its revolving credit facility. The Company's objective is to use free cash flow generated in 2004 to further reduce its long-term debt.

The Company expects the level of capital expenditures in 2004 to be consistent with prior years.

Balance sheet

The Company further improved its financial position in 2003 with a reduction in total borrowings to $36.4 million compared to $43.8 million at the end of the previous year. The total debt to capitalization ratio was 0.32 on December 31, 2003 compared to 0.48 in 2002.

Working capital totalled $86.2 million at the end of 2003 compared to $61.2 million in 2002, reflecting higher trade accounts receivable and inventories. Average working capital in 2003 was $61.2 million compared to $48.4 million in the previous year.

Trade accounts receivable were $93.4 million at the end of 2003, an increase of 34.3% compared to $69.6 million at the end of 2002. This is explained mainly by a higher proportion of sales shipped later in the fourth quarter of 2003 compared to the same period in 2002 and overall growth in International net sales in the fourth quarter of 2003. Such sales typically carry longer selling terms than North American sales.

Inventories were $24.4 million at the end of 2003, compared to $14.5 million at the end of 2002. The increase in inventories was primarily due to the appreciation of the Canadian dollar compared to U.S. currency. The balance is explained mainly by tight inventory management policies by North American retailers during the 2003 Holiday Season. As a result, retailers' inventories of the Company's toys at the end of 2003 were lower than at the end of 2002.

Long-term debt stood at $36.4 million at the end of 2003, an improvement of $7.3 million, or 16.7%, over 2002. The Company does not have any significant debt repayment commitments over the next four years. At the end of 2003, long-term debt was mainly comprised of a $24.6 million term loan, of which $23.8 million is to be repaid in 2008. An additional $10.0 million was outstanding under the Company's revolving credit facility. This revolving credit facility supports the Company's working capital requirements during the peak sales period.

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Significant accounting policies and use of estimates

The Company's consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") using the U.S. dollar (functional currency) as the reporting currency. In preparing the financial statements in conformity with GAAP, management is required 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 Company's significant accounting policies are presented in Note 2 to the financial statements. Management believes that the following accounting policies and estimates are most significant to assist in understanding and evaluating the Company's financial results.

Revenue recognition

Revenue is recognized upon shipment of products to customers. Accruals for customer discounts, rebates and defective allowances are recorded as the related revenues are recognized. Accruals for returns are based on market data, historical trends and information from customers and are therefore subject to estimation.

Financial instruments

The Company uses a combination of financial instruments to manage risks related to fluctuations in exchange rates. The derivative instruments entered into by the Company comprise principally of foreign exchange contracts. The Company formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Gains and losses on foreign exchange contracts are recognized through income and generally offset transaction losses or gains on the foreign currency cash flows, which they are intended to hedge. The Company does not use derivative financial instruments for trading purposes.

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

Stock-based compensation plans

The Company has adopted the fair value method of accounting recommended by the Canadian Institute of Chartered Accountants ("CICA") in Section 3870, "Stock-based Compensation and Other Stock-based Payments", prospectively for new stock-based compensation awards granted after January 1, 2003. The fair value of option awards is recognized as an expense and any consideration paid by employees on exercise of stock options is credited to share capital. The fair value of options is estimated on the date of grant using the Black-Scholes option pricing model, including certain assumptions such as risk-free interest rate, expected life of options and expected volatility of the Company's share price.

Inventories

Inventories are stated at the lower of cost and market value. Cost is established based on the first-in, first-out method. Market value is defined as replacement cost for raw materials and net realizable value for work in process and finished goods.

Risks and uncertainties

Consumer preferences are difficult to predict and the introduction of new products is critical in the Company's industry.

The Company's business and operating results depend largely upon the appeal of its toy products. The Company's continued success in the toy industry will depend on its ability to enhance and extend its existing product lines and to develop, introduce and gain customer acceptance of new products. However, consumer preferences in this industry are continuously changing and are difficult to predict. Individual products typically have short life cycles. There can be no assurance that: (i) any of the Company's current product lines will continue to be popular for any significant period of time; (ii) any new products introduced by the Company will achieve an adequate degree of market acceptance; or (iii) any new products' life cycles will be sufficient to permit the Company to recover development, manufacturing, marketing and other costs.

A decline in the popularity of the Company's existing products or the failure of new products to achieve and sustain market acceptance and to produce acceptable margins could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company's business is dependent on a few of its largest customers, which together account for a majority of its net sales.

A small number of the Company's customers account for a large share of its net sales. For the year ended December 31, 2003, the Company's two largest customers in the aggregate accounted for approximately 39.2% of net sales. Except for outstanding purchase orders for specific products, the Company does not have written contracts with or commitments from any of its customers. If some of these customers were to cease doing business with the Company or to reduce the amount of their purchases from the Company, by virtue of experiencing financial difficulty or otherwise, it could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company is involved in certain significant litigation matters in which the outcome is uncertain.

The Company is currently involved in litigation proceedings, which, regardless of the outcome, may result in substantial expenses and divert the attention of management. The most significant proceeding against the Company involves its principal competitor, Kirkbi AG and LEGO Canada Inc. (collectively referred to as "LEGO"). Although the Company has successfully contested this lawsuit before the Federal Court of Canada, LEGO is seeking leave to appeal the matter to the Supreme Court of Canada, and, if leave is granted, there can be no assurance that the Company will achieve a favorable outcome. In the event that LEGO ultimately succeeds in its claim, a permanent injunction may be issued and the Company could be forced to cease selling some or all of its Micro MEGA BLOKS toys in Canada. The Company may also be required to pay damages. Any or all of the foregoing could have a material adverse effect on the Company's business, financial condition and results of operations.

The toy business is seasonal and therefore the Company's annual operating results will depend, in large part, on its sales during the relatively brief holiday season.

Sales of toy products at retail are seasonal, with a majority of retail sales occurring during the period from September through December. In 2003, approximately 77.6% of the Company's net sales were made during the third and fourth quarters. This seasonality is increasing as large toy retailers become more efficient in their control of inventory levels through just-in-time inventory management systems. As a result, the Company's annual operating results will depend, in large part, on its sales during the relatively brief holiday season. Failure to accurately predict and respond to consumer demand could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company is exposed to fluctuations in the price of the plastic resins it uses to manufacture its products.

The principal raw material used by the Company in the manufacture of its products is plastic resin. The price of plastic resin has experienced fluctuations over the past several years due to volatility in crude oil prices. The Company protects itself against resin price fluctuations by negotiating twelve-month volume commitments with key suppliers while fixing overall prices on a quarterly basis; however, it does not hedge otherwise against adverse price fluctuations. As a result, the Company is currently not protected against plastic resin price volatility beyond a portion of the year.

The Company is exposed to fluctuations in the exchange rate between the U.S. dollar and other currencies.

The Company 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, the Euro, the British pound and the Mexican peso. In the year ended December 31, 2003, over 59.3% of consolidated sales were denominated in U.S. dollars while the majority of expenses were incurred in Canadian dollars. Any weakening in the value of the U.S. dollar against the Canadian dollar could have a material adverse effect on the Company's results of operations.

The Company's policy is to stabilize earnings by limiting foreign currency exposures mainly through forward exchange contracts. Its risk management approach is to have hedging mechanisms in place for a maximum period of 24 months. The hedging policy strictly prohibits unauthorized speculative foreign exchange transactions.

The Company only enters into forward contract agreements with solid financial counter-parties. Furthermore, in order to limit the risk of incurring losses in the event the counterparty does not fulfill its obligation, the Company's policy is to enter into forward exchange contract agreements only with members of its lending syndicate. Therefore, the Company is not required to provide additional security and/or guarantees to the members of the lending syndicate other than the security package already in place for its credit agreement.

Recent accounting pronouncements

Recent accounting changes

The CICA issued Accounting Guideline 14, "Disclosure of Guarantees", with the effective date for financial statements of interim and annual periods beginning on or after January 1, 2003. This guideline provides guidance regarding the identification of guarantees and requires a guarantor to disclose the significant details of guarantees that have been given regardless of whether the guarantor will have to make payments under the guarantees. The Company has no guarantees that require disclosure under this new guideline.

The CICA issued Handbook Section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", which applies to disposal activities initiated by an enterprise's commitment to a plan on or after May 1, 2003. The new section provides guidance on recognizing, measuring, presenting and disclosing long-lived assets to be disposed of and replaces the disposal provisions in Section 3475, "Discontinued Operations" and Section 3061, "Property, Plant and Equipment". The adoption of this new guidance had no significant impact on the consolidated financial statements of the Company.

Future accounting changes

The CICA issued Accounting Guideline 13, "Hedging Relationships", which deals with the identification, documentation, designation and effectiveness of hedges and also the discontinuance of hedge accounting, but does not specify hedge accounting methods. This guidance is applicable to hedge relationships in effect in fiscal years beginning on or after July 1, 2003.

The Company will adopt this Accounting Guideline effective January 1, 2004. The monetary or derivative financial instruments used in risk management and qualifying for hedge accounting will be recorded using the hedge accounting method described under "Financial instruments" in the item "Significant accounting policies and use of estimates".

When the hedging relationship no longer qualifies as an effective hedge, hedge accounting will be discontinued prospectively and the financial instrument will be carried at fair value on the consolidated balance sheet as of the date hedge accounting was discontinued. Any subsequent changes in fair value will be recognized in "Gain/loss on foreign currency translation" in conformity with EIC-128, "Accounting for trading, speculative or non-hedging derivative financial instruments". When the financial instrument once again qualifies as a hedging relationship, hedge accounting will be applied again on as of the new date of designation.

The Company does not believe that the adoption of this new Accounting Guideline will have a material impact on its consolidated financial statements.

The CICA issued Handbook Section 3110, "Asset Retirement Obligations". The new standard focuses on the recognition and measurement of liabilities for obligations associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. The standard is effective for fiscal years beginning on or after January 1, 2004. The Company does not believe that the adoption of this new Section will have a material impact on its consolidated financial statements.

The CICA issued Handbook Section 3063, "Impairment of Long-lived Assets", which is effective for fiscal years beginning on or after April 1, 2003. This section provides guidance on recognizing, measuring and disclosing impairment of long-lived assets. It replaces the write-down provisions in Section 3061, "Property, plant and equipment". The Company does not believe that the adoption of this new Section will have a material impact on its consolidated financial statements.

Forward-looking statements

Certain statements made in this MD&A may constitute forward-looking statements and are subject to significant risks and uncertainties which are difficult to predict and assumptions which may prove to be inaccurate. The results or events predicted in these statements may differ materially from actual results or events. Certain of the risk factors which could cause results or events to differ materially from current expectations include the following: difficulty in predicting customer preferences and importance of new products, dependence on a few large customers, litigation, seasonality of the toy industry, fluctuations in the price of plastic resins and currency fluctuations. The forward-looking statements contained in this document represent the Company's expectations as of March 24, 2004 and, accordingly, are subject to change after such date. However, the Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

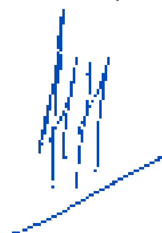
Additional information relating to the Company is available on SEDAR at www.sedar.com.

Management's responsibility for financial statements

The accompanying Consolidated Financial Statements of Mega Bloks Inc. have been prepared by management and approved by the Board of Directors. Management is responsible for the information and representation contained in these financial statements and in other sections of this Annual Report.

To meet its responsibility for the integrity and objectivity of data in the Consolidated Financial Statements, management has developed and maintains a system of internal accounting controls. Management believes that this system of internal accounting controls provides reasonable assurance that the financial records are reliable and form a proper basis for preparation of financial statements, and that the assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for financial statements in this Annual Report principally through its Audit Committee. The Company's auditors have full access to the Audit Committee, with and without management being present. The Consolidated Financial Statements have been audited by Deloitte & Touche LLP Chartered Accountants, and their report is shown as part of the Consolidated Financial Statements.



Marc Bertrand
President and Chief Executive Officer

Alain Tanguay
Vice President and Chief Financial Officer

February 2, 2004

Auditors' report

To the Shareholders of Mega Bloks Inc.

We have audited the consolidated balance sheets of Mega Bloks Inc. as at December 31, 2003 and 2002 and the consolidated statements of earnings, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP
Chartered Accountants

February 2, 2004

Consolidated statements of earnings

(expressed in thousands of U.S. dollars, except per share amounts)	Years ended December 31, 2003	2002
Net sales	$ 219,691	$ 188,807
Cost of sales	117,244	98,816
Gross profit	102,447	89,991
Marketing, research and development, and advertising expenses	28,161	21,701
Other selling, distribution and administrative expenses	35,298	30,047
Gain on foreign currency translation	(4,284)	(223)
Unusual items (Note 10)	–	5,816
Earnings from operations	43,272	32,650
Interest expense		
Long-term debt	1,666	4,516
Other	136	340
	1,802	4,856
Earnings before income taxes	41,470	27,794
Income taxes (Note 11)		
Current	10,123	9,854
Future	2,542	(2,226)
	12,665	7,628
Net earnings	$ 28,805	$ 20,166
Earnings per share (Note 8)		
Basic	$ 1.07	$ 0.83
Diluted	0.98	0.76

Consolidated statements of deficit

(expressed in thousands of U.S. dollars)	Years ended December 31, 2003	2002
Balance, beginning of year		
As previously reported	$ (106,014)	$ (126,504)
Change in accounting policy (Note 2)	–	544
As restated	$ (106,014)	$ (125,960)
Net earnings	28,805	20,166
Related party transaction adjustment (Note 9)	(288)	(220)
Balance, end of year	$ (77,497)	$ (106,014)

See accompanying notes to consolidated financial statements.

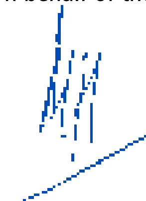
more

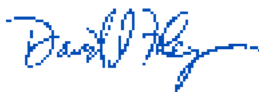
Consolidated balance sheets

(expressed in thousands of U.S. dollars)	As at December 31, 2003	2002
Assets		
Current assets		
Cash and cash equivalents	$ 3,595	$ 2,876
Accounts receivable - trade	93,417	69,556
Accounts receivable - other	4,617	3,092
Inventories (Note 3)	24,440	14,486
Income taxes	24	–
Prepaid expenses	3,823	1,774
	129,916	91,784
Capital assets (Note 4)	33,510	30,318
Deferred charges	1,292	1,592
	$ 164,718	$ 123,694
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	$ 42,782	$ 22,880
Income taxes	–	3,941
Current portion of long-term debt (Note 5)	955	3,742
	43,737	30,563
Long-term debt (Note 5)	35,489	40,015
Future income taxes (Note 11)	8,998	6,067
	88,224	76,645
Shareholders' equity		
Capital stock (Note 6)	153,729	153,063
Contributed surplus (Note 8)	262	–
Deficit	(77,497)	(106,014)
	76,494	47,049
	$ 164,718	$ 123,694

See accompanying notes to consolidated financial statements.

On behalf of the Board,





Marc Bertrand
Director

David I. Foley
Director

Consolidated statements of cash flows

(expressed in thousands of U.S. dollars)	Years ended December 31, 2003	2002
Cash flows from operating activities		
Net earnings	$ 28,805	$ 20,166
Items not affecting cash and cash equivalents		
Amortization of capital assets	7,305	6,649
Amortization of deferred charges	356	463
Stock-based compensation plan (Note 8)	262	–
Loss on disposal of capital assets	–	11
Gain on foreign currency translation	(4,284)	(223)
Future income taxes	2,542	(2,226)
	34,986	24,840
Changes in non-cash operating working capital items (Note 12)	(16,548)	(7,596)
	18,438	17,244
Cash flows from financing activities		
Issuance of capital stock	666	61,514
Proceeds of long-term debt	–	40,000
Repayment of long-term debt	(14,201)	(71,555)
Change in revolving term bank loan balance	6,000	(39,500)
Related party transaction adjustment (Note 9)	(419)	(319)
Increase in deferred charges	–	(2,055)
	(7,954)	(11,915)
Cash flows from investing activities		
Acquisition of capital assets	(9,765)	(9,069)
Proceeds on disposal of capital assets	–	78
	(9,765)	(8,991)
Increase (decrease) in cash and cash equivalents	719	(3,662)
Cash and cash equivalents, beginning of year	2,876	6,538
Cash and cash equivalents, end of year	$ 3,595	$ 2,876

Supplementary disclosure of cash flow information (Note 12).

See accompanying notes to consolidated financial statements.

Notes to consolidated financial statements

years ended December 31, 2003 and 2002
(column figures are expressed in thousands of U.S. dollars, except per share data)

1. Nature of operations

Mega Bloks Inc. (the "Company") designs, manufactures and markets a broad line of construction toys under the MEGA BLOKS brand name that incorporates its system of interlocking plastic building blocks. The Company sells and distributes its products in over 100 countries.

2. Significant accounting policies

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

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.

Principles of consolidation

Consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Cash and cash equivalents

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

Inventories

Inventories are stated at the lower of cost and market value. Cost is established based on the first-in, first-out method. Market value is defined as replacement cost for raw materials and net realizable value for work in process and finished goods.

Capital assets

Capital assets are recorded at cost and are amortized over their estimated useful lives using the straight-line method at the following amortization periods:

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

The Company evaluates the carrying value of its long-lived assets for potential impairment on an ongoing basis. The Company considers projected future operating results, trends and other circumstances in making such evaluations. Impaired assets are written down to a net recoverable amount. No impairment charges have been recorded based on Management's review.

2. Significant accounting policies (cont'd)

Deferred Charges

Deferred charges, comprised of financing charges, are recorded at cost and are amortized according to the straight-line method over the term of the credit facility.

Income taxes

Future income taxes relate to the expected future tax consequences of differences between the carrying amount of balance sheet items and their corresponding tax values. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment or substantive enactment.

Revenue recognition

Revenue is recognized upon shipment of products to customers. Accruals for customer discounts, rebates and defective allowances are recorded as the related revenues are recognized.

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 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.

Effective January 1, 2002, the Company adopted the recommendations of the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1650, "Foreign Currency Translation". The amended recommendations require that all unrealized translation gains and losses on assets and liabilities denominated in foreign currencies be included in earnings for the year, including gains and losses on long-term monetary assets and liabilities, such as long-term debt, which were previously deferred and amortized on a straight-line basis over the remaining lives of the related items. On January 1, 2002, included in deferred credits was $544,000 relating to unrealized foreign currency gains, which was credited to opening deficit.

Financial instruments

The Company uses a combination of financial instruments to manage risks related to fluctuations in exchange rates. The derivative instruments entered into by the Company comprise principally of foreign exchange contracts. The Company formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Gains and losses on foreign exchange contracts are recognized through income and generally offset transaction losses or gains on the foreign currency cash flows, which they are intended to hedge. The Company does not use derivative financial instruments for trading purposes.

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

2. Significant accounting policies (cont'd)

Stock-based compensation plans

On January 1, 2002, the Company adopted the new recommendations of CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments". This Section establishes standards for the recognition, measurement and disclosure of stock-based compensation made in exchange for goods and services. This Section requires that direct awards of stock and liabilities based on the price of common stock be measured at fair value at each reporting date, with any change in fair value reported in the statement of earnings and encourages, but does not require, the use of the fair value method for all other types of stock-based compensation plans. The new standard also requires pro-forma disclosures relating to net earnings and earnings per share figures as if the fair value method of accounting had been used. This Section applies to awards granted on or after January 1, 2002.

None of the Company's plans qualify as direct awards of stock or as plans that create liabilities based on the price of Company's stock, and as a result, the implementation of the Section had no impact on the consolidated financial statements. The Company has chosen not to use the fair value method to account for stock-based compensation plans for options granted in 2002. The pro-forma disclosure is presented in Note 8.

Effective January 1, 2003, the Company adopted the fair value method of accounting recommended by the CICA in Section 3870, "Stock-based Compensation and Other Stock-based Payments", prospectively for new stock-based compensation awards granted after January 1, 2003. The impact of this adoption is included in Note 8. Any consideration paid by employees on exercise of stock options is credited to capital stock.

Government grants

Government grants for capital asset acquisitions are netted against capital assets and are amortized on the same basis as the related asset. Government grants to create employment are recorded in earnings as a reduction of the related expenses when conditions are met (see Note 14).

Recent accounting changes

The CICA issued Accounting Guideline 14, "Disclosure of Guarantees", with the effective date for financial statements of interim and annual periods beginning on or after January 1, 2003. This guideline provides guidance regarding the identification of guarantees and requires a guarantor to disclose the significant details of guarantees that have been given regardless of whether the guarantor will have to make payments under the guarantees. The Company has no guarantees that require disclosure under this new guideline.

The CICA issued Handbook Section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", which applies to disposal activities initiated by an enterprise's commitment to a plan on or after May 1, 2003. The new Section provides guidance on recognizing, measuring, presenting and disclosing long-lived assets to be disposed of and replaces the disposal provisions in Section 3475, "Discontinued Operations" and Section 3061, "Property, Plant and Equipment". The adoption of this new guidance had no significant impact on the consolidated financial statements of the Company.

2. Significant accounting policies (cont'd)

Future accounting changes

The CICA issued Accounting Guideline 13, "Hedging Relationships", which deals with the identification, documentation, designation and effectiveness of hedges and also the discontinuance of hedge accounting, but does not specify hedge accounting methods. This guidance is applicable to hedge relationships in effect in fiscal years beginning on or after July 1, 2003.

The Company will adopt this Accounting Guideline effective January 1, 2004. The monetary or derivative financial instruments used in risk management and qualifying for hedge accounting will be recorded using the hedge accounting method described in "Financial instruments".

When the hedging relationship no longer qualifies as an effective hedge, hedge accounting will be discontinued prospectively and the financial instrument will be carried at fair value on the consolidated balance sheet as of the date hedge accounting was discontinued. Any subsequent changes in fair value will be recognized in "Gain/loss on foreign currency translation" in conformity with EIC-128, "Accounting for trading, speculative or non-hedging derivative financial instruments". When the financial instrument once again qualifies as a hedging relationship, hedge accounting will be applied again as of the new date of designation.

The Company does not believe that the adoption of this new Accounting Guideline will have a material impact on its consolidated financial statements.

The CICA issued Handbook Section 3110, "Asset Retirement Obligations". The new standard focuses on the recognition and measurement of liabilities for obligations associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. The standard is effective for fiscal years beginning on or after January 1, 2004. The Company does not believe that the adoption of this new Section will have a material impact on its consolidated financial statements.

The CICA issued Handbook Section 3063, "Impairment of Long-lived Assets", which is effective for fiscal years beginning on or after April 1, 2003. This section provides guidance on recognizing, measuring and disclosing impairment of long-lived assets. It replaces the write-down provisions in Section 3061, "Property, plant and equipment". The Company does not believe that the adoption of this new Section will have a material impact on its consolidated financial statements.

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3. Inventories

		2003		2002
Raw materials	$	**551**	$	259
Work in progress		**9,467**		5,594
Finished goods		**14,422**		8,633
	$	**24,440**	$	14,486

4. Capital assets

				2003		
		Cost		**Accumulated amortization**		**Net book value**
Machinery and equipment	$	**56,059**	$	**29,176**	$	**26,883**
Computer equipment		**4,634**		**2,522**		**2,112**
Leasehold improvements		**3,471**		**654**		**2,817**
Machinery and equipment held under capital leases		**1,473**		**187**		**1,286**
Computer equipment held under capital leases		**1,454**		**1,042**		**412**
	$	**67,091**	$	**33,581**	$	**33,510**

				2002		
		Cost		Accumulated amortization		Net book value
Machinery and equipment	$	48,116	$	23,173	$	24,943
Computer equipment		3,502		1,905		1,597
Leasehold improvements		2,780		323		2,457
Machinery and equipment held under capital leases		741		62		679
Computer equipment held under capital leases		1,454		812		642
	$	56,593	$	26,275	$	30,318

5. Long-term debt

	2003	2002
Term loan of $25.0 million, secured, maturing in May 2008[1]	$ 24,625	$ 24,875
Revolving term bank loan of $45.0 million, secured, of which the revolving period matures in May 2007[2]	10,000	4,000
Obligations under capital leases maturing at various dates up to May 2008[3]	1,767	1,247
Loans, secured, maturing at various dates up to June 2004[4]	52	135
Term loans, secured, repaid in 2003[5]	–	13,500
	36,444	43,757
Current portion	955	3,742
	$ 35,489	$ 40,015

(1) Bearing interest at a floating rate based on U.S. Base Rate plus 2.00% to 3.50% or LIBOR rate plus 3.00% to 4.50%, at the option of the Company, of which 95% is repaid at maturity, secured by a moveable hypothec on all assets of the Company.

(2) Bearing interest at a floating rate based on U.S. Base Rate plus 1.50% to 3.00% or LIBOR rate plus 2.50% to 4.00%, at the option of the Company, secured by a moveable hypothec on all assets of the Company.

(3) Obligations denominated in Canadian dollars, bearing interest at rates ranging between 5.82% and 10.57%.

(4) Loans denominated in Canadian dollars, bearing interest at rates ranging between 8.88% and 9.07%, secured by computer equipment having a net book value of $0.2 million.

(5) Bearing interest at a floating rate based on U.S. Base Rate plus 1.50% to 3.00% or LIBOR rate plus 2.50% to 4.00% at the option of the Company, repayable in equal annual installments, secured by a movable hypothec on all assets of the Company.

Under the conditions of the credit agreement, the Company must satisfy certain restrictive covenants as to financial ratios.

Payments required in each of the next five years on the long-term debt are as follows:

	Obligations under capital leases			Other debt	Total
Years	Minimum payments	Interest	Principal	Principal	principal payments
2004	$ 764	$ 111	$ 653	$ 302	$ 955
2005	359	67	292	250	542
2006	341	46	295	250	545
2007	377	26	351	10,125	10,476
2008	180	4	176	23,750	23,926
	$ 2,021	$ 254	$ 1,767	$ 34,677	$ 36,444

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6. Capital stock

The capital stock of the Company is as follows:

Authorized

An unlimited number of common shares without par value.

An unlimited number of preferred shares issuable in series, without par value, non-voting, entitling the holder to receive dividends in priority to the holders of common shares as and when declared by the Board of Directors.

Issued and outstanding

	2003		2002	
	Shares	**Book value**	Shares	Book value
Class A common shares				
Balance, beginning of year	–	$ –	19,226,331	$ 19,908
Converted from Class B	–	–	141,923	99
Converted from Class C	–	–	155,997	69,710
Redesignated to Common Shares	–	–	(19,524,251)	(89,717)
Issued	–	–	–	–
Balance, end of year	–	–	–	–
Class B common shares				
Balance, beginning of year	–	–	141,923	99
Converted to Class A	–	–	(141,923)	(99)
Balance, end of period	–	–	–	–
Class C common shares				
Balance, beginning of year	–	–	155,997	69,710
Converted to Class A	–	–	(155,997)	(69,710)
Balance, end of year	–	–	–	–
Common shares				
Balance, beginning of year	**26,881,061**	**153,063**	–	–
Redesignated from Class A	–	–	19,524,251	89,717
Issued pursuant to Initial Public Offering	–	–	7,250,000	62,853
Issued pursuant to US employee plan	–	–	34,110	315
Issued pursuant to exercise of stock options	**238,471**	**666**	72,700	178
Balance, end of period	**27,119,532**	**153,729**	26,881,061	153,063
Total	**27,119,532**	**$ 153,729**	26,881,061	$ 153,063

6. Capital stock (cont'd)

Share capital reorganization and Initial Public Offering

On March 20, 2002, the Company amended its articles of incorporation thereby cancelling all the authorized but unissued Class A through Class G preferred shares.

On May 9, 2002, immediately prior to the closing of the Initial Public Offering, the Company completed a capital reorganization whereby:

(i) all holders of the issued and outstanding Class B and Class C common shares converted such shares into Class A common shares on a share for share basis; and,

(ii) the Company's articles were amended to:

  (a) Modify certain provisions attached to Class A common shares;
  (b) Subdivide all the issued and outstanding Class A common shares on the basis of 13 Class A common shares for each Class A common share;
  (c) Redesignate the Class A common shares to common shares; and,
  (d) Cancel all authorized but unissued classes of common shares.

On May 9, 2002, the Company successfully closed its Initial Public Offering. Through this Initial Public Offering, the Company issued 7,250,000 common shares from the treasury at a price of CA$14.50 per share, resulting in gross proceeds of CA$105.1 million or $66.9 million before share issue costs of $4.0 million (net of income taxes of $1.8 million). Concurrently with the Initial Public Offering, the Company issued 34,110 common shares from the treasury at a price of CA$14.50 per share, resulting in net proceeds of CA$0.5 million or $0.3 million.

All 2002 share and per share amounts presented herein have been adjusted to reflect the subdivision of shares in 2002.

7. Stock-based compensation plans

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

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

Under the New Stock Option Plan, options to purchase common shares of the Company are granted at a subscription price of 100% of market value. Market value is determined as the closing price of the common shares on the Toronto Stock Exchange on the last day of trading prior to the effective date of the grant.

At December 31, 2003, a total of 6,152,364 common shares (6,398,154 in 2002) remained authorized for issuance under the Company's stock-based compensation plans. Options are exercisable during a period not exceeding 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 Company, the options become immediately exercisable. Options are adjusted proportionately for any stock dividends or stock splits attributed to the common shares of the Company.

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7. Stock-based compensation plans (cont'd)

The following table summarizes total stock options outstanding at December 31 under the Company's Stock Option plans:

	2003		2002	
	Number of options	**Weighted average exercise price**	Number of options	Weighted average exercise price
(in Canadian dollars)				
Options outstanding, beginning of year	**3,925,483**	**$ 7.76**	2,578,173	$ 3.85
Granted	**210,800**	**20.99**	1,462,629	14.60
Exercised	**(238,471)**	**3.99**	(72,700)	3.85
Forfeited	**(30,987)**	**14.01**	(42,619)	12.67
Options outstanding, end of year	**3,866,825**	**$ 8.66**	3,925,483	$ 7.76
Options exercisable, end of year	**2,572,239**	**$ 5.22**	2,435,676	$ 3.85

The following table summarizes information about fixed stock options outstanding at December 31, 2003:

Range of exercise price	**Number outstanding**	**Weighted average remaining contractual life**	**Weighted average exercise price**	**Number exercisable**	**Weighted average exercise price**
(in Canadian dollars)					
$ 3.85	**2,255,477**	**5.8**	**$ 3.85**	**2,242,477**	**$ 3.85**
$ 14.50 to $ 25.65	**1,611,348**	**8.5**	**15.40**	**329,762**	**14.53**
Total	**3,866,825**	**6.9**	**$ 8.66**	**2,572,239**	**$ 5.22**

All 2002 share and per share amounts presented herein have been adjusted to reflect the subdivision of shares in 2002.

8. Earnings per share

A reconciliation between basic and diluted earnings per share is as follows:

	2003	2002
Numerator for basic and diluted net earnings per common share:		
Net earnings attributable to common shareholders	**$ 28,805**	$ 20,166
Denominator for basic net earnings per common share:		
Weighted average number of common shares outstanding	**26,992,797**	24,261,617
Basic earnings per share	**$ 1.07**	$ 0.83
Denominator for diluted net earnings per common share:		
Weighted average number of common shares outstanding	**26,992,797**	24,261,617
Plus impact of stock options	**2,444,265**	2,205,793
Diluted common shares	**29,437,062**	26,467,410
Diluted earnings per share	**$ 0.98**	$ 0.76

8. Earnings per share (cont'd)

For the year ended December 31, 2003, 205,400 outstanding share options were not included in the computation of diluted earnings per share. With regards to these options, the exercise prices were greater than the average market price of the common shares during the year or the effect of the amount of compensation cost attributed to future services and not yet recognized is anti-dilutive.

Fair value method for the Company's stock based compensation plan

CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments", recommends the recognition of an expense for option awards using the fair value method of accounting for options issued after January 1, 2002. It permits the use of other methods, including the intrinsic value based method, provided pro forma disclosures of net income and earnings per share applying the fair value method are made. The Company adopted the recommendations of CICA Handbook Section 3870, with respect to the use of the fair value method to recognize an expense for option awards, prospectively for new awards granted after January 1, 2003. The fair value compensation expense recorded for the year ended December 31, 2003, in respect of these awards was $0.3 million.

The pro forma disclosures have been presented as if the recommended recognition provisions of Section 3870, for awards granted before 2003 had been adopted in 2003 and 2002.

	As reported		Pro forma [1]	
	2003	2002	**2003**	2002
Net earnings	**$ 28,805**	$ 20,166	**$ 26,448**	$ 18,679
Earnings per share	**$ 1.07**	$ 0.83	**$ 0.98**	$ 0.77
Diluted earnings per share	**$ 0.98**	$ 0.76	**$ 0.90**	$ 0.70

[1] Compensation expense under the fair value based method is recognized over the vesting period of the related stock options. Accordingly, the pro forma results of applying this method may not be indicative of future amounts.

The fair value of options granted during 2003 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	2003	2002
Risk-free interest rate	**4.89%**	5.64%
Expected option life	**6 years**	8 years
Expected volatility	**27%**	33%
Expected dividends	**0%**	0%

The fair value of each option granted was CA$7.82 (CA$7.37 in 2002).

All 2002 share and per share amounts presented herein have been adjusted to reflect the subdivision of shares in 2002.

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9. Related party transactions

Related party transaction adjustment

On May 29, 2003, the Company closed a secondary offering through a filing of Base Prospectus with Canadian securities regulatory authorities. The secondary offering qualified the distribution of 6,223,240 common shares (the "Offered Shares") of the Company owned by certain shareholders. The Company did not receive any proceeds from the sale of the Offered Shares. The expenses (other than the Underwriters' fees) of the offering paid by the Company in the amount of approximately $419,000 ($288,000 net of income taxes) were recorded as a related party transaction adjustment reflected as an increase in deficit.

On November 22, 2002, the Company closed a secondary offering through a filing of Base Prospectus with Canadian securities regulatory authorities. The secondary offering qualified the distribution of 6,250,000 common shares (the "Offered Shares") of the Company owned by certain shareholders. The Company did not receive any proceeds from the sale of the Offered Shares. The expenses (other than the Underwriters' fees) of the offering paid by the Company in the amount of approximately $319,000 ($220,000 net of income taxes) were recorded as a related party transaction adjustment reflected as an increase in deficit.

Other

During the year, monitoring and consulting fees in the amount of $307,000 ($571,000 in 2002) were charged by certain shareholders of the Company. Accounts payable and accrued liabilities as at December 31, 2003 were nil ($190,000 as at December 31, 2002) to certain shareholders of the Company. These transactions were carried out in the normal course of business and have been accounted for at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

10. Unusual items

		2003		2002
Liquidity event award[1]	$	–	$	2,567
Cancellation of previous credit facility[2]		–		2,309
Charges incurred to settle CRA's tax audit[3]		–		720
Others		–		220
	$	–	$	5,816

[1] The Company granted selected executives and other key employees a Liquidity Event Award that entitles the holder to receive a bonus based upon the occurrence of certain future corporate events ("Liquidity Event"). These future events have been identified as a change in control or a public offering that would result in an active market of at least 25% of common stock. The amount of the liquidity bonus would be payable, however, only upon the date on which stock options become vested and exercisable pursuant to the Initial Stock Option Plan. On May 9, 2002, the Initial Public Offering constituted a Liquidity Event under the Liquidity Event Award and, accordingly, the Company recorded a provision of $2.6 million, of which $2.2 million was paid during 2002 and $0.4 million during 2003.

[2] On May 9, 2002, the Company used the net proceeds of its Initial Public Offering closed on that date together with the proceedsfrom its new term loans to repay all its outstanding term and revolving term loans. A prepayment penalty for the cancellation of the previous credit facility totalling $2.3 million was incurred and recorded as an unusual item.

[3] See note 11c) for a description of the Canada Revenue Agency ("CRA") tax audit and its outcome.

11. Income taxes

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

		2003		2002
Income tax expense at statutory rate	$	**13,463**	$	10,137
Manufacturing tax credit		**(519)**		(927)
Non-deductible items		**147**		174
Unrealized gain on foreign exchange currency		**(980)**		(160)
Tax provision and other		**554**		(1,596)
Income tax expense	$	**12,665**	$	7,628

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

		2003		2002
Future income tax assets				
Share issue costs	$	**1,516**	$	1,699
Other		**406**		219
		1,922		1,918
Future income taxes liabilities				
Capital assets		**7,657**		6,146
Unrealized portion of foreign exchange gain		**971**		–
Tax provision and other		**2,292**		1,839
		10,920		7,985
Future income taxes, net	$	**(8,998)**	$	(6,067)

c) During 2002, the Company received a proposal for reassessment from the CRA covering the Company's 1996 to 1999 taxation years, which it accepted. Through this proposal, the CRA disallowed treatment of certain expenses deducted by the Company. Expenses disallowed by the CRA were mostly related to the 1996 re-capitalization transaction. The Company estimated that the total amount of income taxes otherwise payable, including all interest to be accrued following the disallowance of these expenses would total approximately $1.2 million. During 2001, the Company recorded a non-recurring tax provision of $3.0 million in connection with the tax audit performed by the CRA. Accordingly, approximately $1.8 million of the non-recurring tax provision was reversed against earnings as a reduction of income tax expense during 2002.

12. Statement of cash flows

	2003	2002
a) Changes in non-cash operating working capital items:		
Accounts receivable - trade	$ **(23,861)**	$ (13,849)
Accounts receivable - other	**(1,525)**	59
Inventories	**(9,954)**	(2,460)
Prepaid expenses	**(2,049)**	(1,111)
Accounts payable and accrued liabilities	**19,902**	6,267
Income taxes	**(3,834)**	5,278
Foreign currency translation relating to working capital items	**4,773**	(1,780)
	$ **(16,548)**	$ (7,596)

	2003	2002
b) Supplementary information:		
Interest paid	$ **1,626**	$ 5,216
Income taxes paid	$ **12,376**	$ 7,199

c) During the year, capital assets were acquired at an aggregate cost of $10,497,000 ($10,016,000 in 2002) of which $732,000 ($947,000 in 2002) was acquired by means of capital leases and which is netted from a government grant of $214,000 ($498,000 in 2002), received for acquisition of capital assets.

13. Financial instruments

Foreign currency risk management

The Company 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, the Euro, the British pound and the Mexican peso. Sales are primarily denominated in U.S. dollars while the majority of its expenses are incurred in Canadian dollars.

The Company's policy is to mitigate, when appropriate, its exposure to market risk by partially hedging such exposure using foreign currency contracts primarily to hedge expenses denominated in Canadian dollars and inter-company transactions denominated in other foreign currencies.

The following table summarizes the Company's foreign currency commitments as at December 31, 2003 and 2002:

Foreign currency contracts	Notional amount	Average exchange rate	Maturing up to	Notional equivalent	Fair market value including notional equivalent
	$			US $	US $
2003					
Sell - $US to $CAN	**32,000**	**1.5968**	**Dec. 2004**	**32,000**	**39,122**
- Euro to $US	**48,500**	**1.1275**	**Dec. 2005**	**54,684**	**49,470**
- Euro to $CAN	**6,000**	**1.6489**	**Dec. 2004**	**7,655**	**7,736**
- GBP to $US	**12,000**	**1.6686**	**Dec. 2005**	**20,023**	**19,289**
2002					
Sell - $US to $CAN	77,500	1.5887	Dec. 2004	77,500	77,583
- Euro to $US	18,400	1.0074	Dec. 2004	18,537	17,933
- Euro to $CAN	6,000	1.6489	Dec. 2004	6,180	6,153

13. Financial instruments (cont'd)

Credit risk

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of trade receivables.

The Company regularly monitors its credit risk exposure and takes steps to mitigate the risk of loss, including obtaining credit insurance. The Company's extension of credit is based on an evaluation of each customer's financial condition and the Company's ability to obtain credit insurance coverage for that customer.

Fair value

The Company has determined that the carrying value of its short-term financial assets and liabilities approximates fair values as at the balance sheet dates because of the short-term maturity of those instruments.

The fair value of the Company's long-term debt approximates its carrying value as the majority of long-term debt bears interest at rates that vary based on the LIBOR and U.S. base rate.

Interest rates

The Company is exposed to market risks from changes in interest rates on its long-term debt and does not currently hold any financial instruments that mitigate this risk.

14. Commitments and contingencies

a) On July 14, 2003, the Federal Court of Appeal of Canada released a decision dismissing, with costs, the appeal filed by LEGO from the May 2002 decision of the Federal Court Trial Division. LEGO has filed a request for leave to appeal to the Supreme Court of Canada. A decision from the Supreme Court on this leave application is expected in the next few months. The decision of the Court of Appeal of Canada shall become final if leave is refused. Through this action, LEGO claimed exclusive rights in the "look" of the knobs on its standard LEGO brick and alleged that the manufacture and sale of the Company's Micro MEGA BLOKS construction blocks constituted passing off pursuant to the Trade-marks Act. The Company and its legal counsel believe that it is unlikely that LEGO's appeal will be successful.

b) The Company is also defending other claims, which arise in the ordinary course of business. The Company believes that the outcome of any individual claim or the aggregate of all such claims will not have a material impact on the Company's business, financial condition and results of operations.

c) The Company has entered into operating leases for premises, which it occupies, for an amount of $28,675,000. The minimum annual rent payable (excluding certain occupancy charges) for each of the next five years, is as follows:

2004	$	3,533
2005		3,657
2006		3,660
2007		3,835
2008		3,904

14. Commitments and contingencies (cont'd)

d) In connection with an agreement with Investissement Québec, an aggregate amount of CA$3,900,000 will be granted to the Company over a period of three years. This grant is conditional upon acquiring a certain level of capital assets and to the creation and maintenance of a certain level of employment for a period of five years. During the year, the Company received a grant in an amount of $214,000 to acquire certain capital assets which was accounted for as a reduction of capital assets and a grant of $619,000 as part of employment creation.

During 2001 and 2002, the Company received grants in an amount of $1,023,000 to acquire certain capital assets and to create employment. 90% of the grants received in 2001 and 2002 were accounted for as a reduction of capital assets. The remaining portion of the grants will be recorded in earnings as a reduction of related expenses when conditions are met (see Note 2).

e) As at December 31, 2003, the Company had outstanding letters of guarantee in the amount of $1,364,000 ($1,161,000 in 2002) relating to financial guarantees issued in the normal course of business. These guarantees are issued under standby facilities available to the Company through various financial institutions.

15. Segmented information

The Company manages its business as a single operating segment – manufacturing and distribution of toys.

Major customers and revenue by geographic areas:

a) Net sales to the Company's two largest customers amounted to $50.1 million ($50.3 million in 2002) and $35.9 million ($33.6 million in 2002).

b) Net sales were derived from customers located in the following geographic areas:

		2003		2002
Canada	$	**16,642**	$	13,445
United States		**121,399**		118,715
International		**81,650**		56,647
	$	**219,691**	$	188,807

Capital assets by geographic areas are as follows:

		2003		2002
Canada	$	**33,290**	$	30,072
International		**220**		246
	$	**33,510**	$	30,318

16. Comparative figures

Certain comparative figures have been reclassified to conform with the presentation adopted for the current year.

Directors, officers and senior management

Directors

Victor J. Bertrand
Chairman of the Board
Mega Bloks Inc.

Marc Bertrand
President and Chief Executive Officer
Mega Bloks Inc.

Vic Bertrand
Executive Vice President and Chief Operating Officer
Mega Bloks Inc.

Michel Coutu [1,2,3]
President and Chief Executive Officer
The Jean Coutu Group (PJC) USA Inc.

Jean-Guy Desjardins [3]
Chairman and Chief Executive Officer
of Centria Inc. and Fiera Capital Management Inc.

David I. Foley [1,2]
Principal in the Private Equity Group
of The Blackstone Group

Peter T. Main [3]
Former Executive Vice President
Nintendo of America Inc.

Paula Rozicki-Howell [1,2]
Managing Director
TBWA Toronto

(1) Member Corporate Governance Commitee
(2) Member Compensation Committee
(3) Member Audit Committee

Officers and senior management

Marc Bertrand
President and Chief Executive Officer

Vic Bertrand
Executive Vice President and Chief Operating Officer

Alain Tanguay
Vice President and Chief Financial Officer

Brahm Segal
Vice President Corporate Affairs and Corporate Secretary

Drew Stevenson
Vice President North American Sales

Gerardo Yepez Reyna
Vice President and General Manager
Mega Bloks Europe

Jean-François Albert
Vice President Human Resources

Yvon Barbeau
Vice President Supply Chain

Daniel Bourgeois
Vice President Design & Development Preschool

Sylvain Duval
Vice President Operations

Rod Dorman
Vice President Marketing

Dominique Roy
Vice President Design & Development Boys 5+

Tim Wills
Vice President Brand Management Boys 5+

more

Shareholder information

Headquarters

4505 Hickmore
Montreal, QC
Canada H4T 1K4
Tel.: 514.333.5555
Fax: 514.333.4470

Listing

The Toronto Stock Exchange
Ticker Symbol: MB

Shares outstanding

27,119,532 Common Shares
(as of December 31, 2003)

Fiscal 2003 trading history

High:	CA$ 26.00
Low:	CA$ 19.02
Close:	CA$ 23.00
Average daily volume:	64,523 shares

Transfer agent

CIBC Mellon Trust Company
1.800.387.0825

Auditors

Deloitte & Touche LLP

Investor relations

For further information about the Company, additional copies of this report or other financial information, please contact:

Eric Phaneuf
514.333.3339 ext. 745

You may also contact us by e-mail at **info_invest@megabloks.com** or by visiting our Web site at **www.megabloks.com**.

Annual general meeting of shareholders

Friday, May 7, 2004 at 10:00 a.m.
Hotel Sheraton
Salle de Bal Ouest
1201 Rene-Levesque Blvd. West
Montreal, QC

This Annual Report is also available at **www.megabloks.com**.

Le rapport annuel 2003 de Mega Bloks est également publié en français.

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