



Q4 Quarterly Report

Fourth quarter ended December 31, 2003



Stock Exchange

Toronto Stock Exchange: MB

Shares Outstanding

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

Fourth Quarter Fiscal 2003 Trading History

TSX	(CA\$)
High:	\$26.00
Low:	\$21.95
Close:	\$23.00
Average volume:	61,251

Transfer Agent

CIBC Mellon Trust Company
1.800.387.0825

Financial Highlights

(all figures in millions of U.S. dollars, except per share amounts)

	Q4 2003	Q4 2002
Net sales	\$92.1	\$80.9
Earnings from operation	\$22.2	\$22.2
Net earnings	\$16.1	\$13.7
Earnings per share		
- Basic	\$0.59	\$0.51
- Diluted	\$0.55	\$0.47

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Results of operations

The following table presents a summary of selected consolidated financial information for the fourth quarter and fiscal year ended December 31, 2003 on a comparable basis to the same periods of the previous year:

	Three-month periods ended December 31,				Twelve-month periods ended December 31,			
	2003		2002		2003		2002	
	\$	% of net sales	\$	% of net sales	\$	% of net sales	\$	% of net sales
<small>(All figures in thousands of U.S. dollars, except per share amounts)</small>								
Net sales	92,094	100.0%	80,876	100.0%	219,691	100.0%	188,807	100.0%
Cost of sales	49,542	53.8%	41,139	50.9%	117,244	53.4%	98,816	52.3%
Gross profit	42,552	46.2%	39,737	49.1%	102,447	46.6%	89,991	47.7%
Marketing, research and development, and advertising expenses	10,659	11.6%	8,375	10.4%	28,161	12.8%	21,701	11.5%
Other selling, distribution and administrative expenses	11,211	12.2%	9,402	11.6%	35,298	16.1%	30,047	15.9%
Gain on foreign currency translation	(1,557)	(1.7%)	(198)	(0.2%)	(4,284)	(2.0%)	(223)	(0.1%)
Unusual items	-	0.0%	-	0.0%	-	0.0%	5,816	3.1%
Earnings from operations	22,239	24.1%	22,158	27.4%	43,272	19.7%	32,650	17.3%
Interest expense, net	265	0.3%	1,254	1.6%	1,802	0.8%	4,856	2.6%
Earnings before income taxes	21,974	23.9%	20,904	25.8%	41,470	18.9%	27,794	14.7%
Income taxes	5,840	6.3%	7,176	8.9%	12,665	5.8%	7,628	4.0%
Net earnings	16,134	17.5%	13,728	17.0%	28,805	13.1%	20,166	10.7%
Earnings per share								
Basic	0.59		0.51		1.07		0.83	
Diluted	0.55		0.47		0.98		0.76	
Weighted average number of outstanding shares								
Basic	27,117,037		26,838,838		26,992,767		24,261,617	
Diluted	29,557,515		29,272,628		29,437,062		26,467,410	
Canadian Dollar Data ⁽¹⁾								
Net sales	119,022		104,524		283,929		244,014	
Net earnings	20,852		17,742		37,228		26,063	
Earnings per share								
Basic	0.77		0.66		1.38		1.07	
Diluted	0.71		0.61		1.26		0.98	

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

Consolidated statements of earnings

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

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003 (Unaudited)	2002 (Unaudited)	2003 (Audited)	2002 (Audited)
Net sales	\$ 92,094	\$ 80,876	\$ 219,691	\$ 188,807
Cost of sales	49,542	41,139	117,244	98,816
Gross profit	42,552	39,737	102,447	89,991
Marketing, research and development, and advertising expenses	10,659	8,375	28,161	21,701
Other selling, distribution and administrative expenses	11,211	9,402	35,298	30,047
Gain on foreign currency translation	(1,557)	(198)	(4,284)	(223)
Unusual items (Note 10)	—	—	—	5,816
Earnings from operations	22,239	22,158	43,272	32,650
Interest expense				
Long-term debt	268	1,197	1,666	4,516
Other	(3)	57	136	340
	265	1,254	1,802	4,856
Earnings before income taxes	21,974	20,904	41,470	27,794
Income taxes (Note 11)				
Current	5,531	7,870	10,123	9,854
Future	309	(694)	2,542	(2,226)
	5,840	7,176	12,665	7,628
Net earnings	\$ 16,134	\$ 13,728	\$ 28,805	\$ 20,166
Earnings per share (Note 8)				
Basic	\$ 0.59	\$ 0.51	\$ 1.07	\$ 0.83
Diluted	0.55	0.47	0.98	0.76

Consolidated statements of deficit

(in thousands of U.S. dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003 (Unaudited)	2002 (Unaudited)	2003 (Audited)	2002 (Audited)
Balance, beginning of period				
As previously reported	\$ (93,631)	\$ (119,522)	\$ (106,014)	\$ (126,504)
Change in accounting policy (Note 2)	–	–	–	544
As restated	(93,631)	(119,522)	(106,014)	(125,960)
Net earnings	16,134	13,728	28,805	20,166
Related party transaction adjustment (Note 9)	–	(220)	(288)	(220)
Balance, end of period	\$ (77,497)	\$ (106,014)	\$ (77,497)	\$ (106,014)

Consolidated balance sheets

(in thousands of U.S. dollars)

	December 31,	December 31,
	2003	2002
	(Audited)	(Audited)
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

Consolidated statements of cash flows

(in thousands of U.S. dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003 (Unaudited)	2002 (Unaudited)	2003 (Audited)	2002 (Audited)
Cash flows from operating activities				
Net earnings	\$ 16,134	\$ 13,728	\$ 28,805	\$ 20,166
Items not affecting cash and cash equivalents				
Amortization of capital assets	1,596	2,744	7,305	6,649
Amortization of deferred charges	90	86	356	463
Stock-based compensation plan (Note 8)	262	—	262	—
Loss on disposal of capital assets	—	11	—	11
Gain on foreign currency translation	(1,557)	(198)	(4,284)	(223)
Future income taxes	309	(694)	2,542	(2,226)
	16,834	15,677	34,986	24,840
Changes in non-cash operating working capital items (Note 12)	(14,321)	4,602	(16,548)	(7,596)
	2,513	20,729	18,438	17,244
Cash flows from financing activities				
Issue of capital stock	18	(1,654)	666	61,514
Proceeds of long-term debt	—	—	—	40,000
Repayment of long-term debt	(135)	(1,704)	(14,201)	(71,555)
Change in revolving term bank loan balance	(1,500)	(15,000)	6,000	(39,500)
Related party transaction adjustment (Note 9)	—	(319)	(419)	(319)
Increase in deferred charges	—	—	—	(2,055)
	(1,617)	(18,677)	(7,954)	(11,915)
Cash flows used in investing activities				
Acquisition of capital assets	(1,607)	(1,031)	(9,765)	(9,069)
Proceeds on disposal of capital assets	—	78	—	78
	(1,607)	(953)	(9,765)	(8,991)
Increase (decrease) in cash and cash equivalents	(711)	649	719	(3,662)
Cash and cash equivalents, beginning of period	4,306	2,227	2,876	6,538
Cash and cash equivalents, end of period	\$ 3,595	\$ 2,876	\$ 3,595	\$ 2,876

Supplementary disclosure of cash flow information (Note 12)



Notes to consolidated financial statements

For the three-month and twelve-month periods ended December 31, 2003 and 2002
(Columns 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 at the date of acquisition.

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 annual amortization rates:

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.

Deferred Charges

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





2. Significant accounting policies (continued)

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 US 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 expenses 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 translations 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 (continued)

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 share capital.

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.

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 on 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.

2. Significant accounting policies (continued)

Future accounting changes (continued)

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.

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
Computer equipment held under capital leases	1,454	1,042	412
Machinery and equipment held under capital leases	1,473	187	1,286
	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
Computer equipment held under capital leases	1,454	812	642
Machinery and equipment held under capital leases	741	62	679
	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 loan, 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 US 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 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:

Years	Obligations under capital leases			Other debt	Total principal repayments
	Minimum payments	Interest	Principal	Principal	
	\$	\$	\$	\$	\$
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

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	
	Share	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 year	–	–	–	–
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 year	27,119,532	153,729	26,881,061	153,063
Total	27,119,532	153,729	26,881,061	153,063



6. Capital stock (continued)

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.

7. Stock-based compensation plans (continued)

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 (CA\$)	Number of options	Weighted average exercise price (CA\$)
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 as at December 31, 2003:

Range of exercise price (CA\$)	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price (CA\$)	Number exercisable	Weighted average exercise price (CA\$)
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:

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003	2002	2003	2002
Numerator for basic and diluted net earnings per common share:				
Net income attributable to common shareholders	\$ 16,134	\$ 13,728	\$ 28,805	\$ 20,166
Denominator for basic net income per common share:				
Weighted average number of common shares outstanding	27,117,037	26,838,838	26,992,797	24,261,617
Basic earnings per share	\$ 0.59	\$ 0.51	\$ 1.07	\$ 0.83
Denominator for diluted net income per common share:				
Weighted average number of common shares outstanding	27,117,037	26,838,838	26,992,797	24,261,617
Plus impact of stock options	2,440,478	2,433,790	2,444,265	2,205,793
Diluted common shares	29,557,515	29,272,628	29,437,062	26,467,410
Diluted earnings per share	\$ 0.55	\$ 0.47	\$ 0.98	\$ 0.76

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.

8. Earnings per share (continued)

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

CICA 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 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 CICA 3870 for awards granted before 2003 had been adopted in 2003 and 2002.

Three-month periods ended December 31	As reported		Pro forma ⁽¹⁾	
	2003	2002	2003	2002
	\$	\$	\$	\$
Net earnings	16,134	13,728	15,840	13,170
Earnings per share	0.59	0.51	0.58	0.49
Diluted earnings per share	0.55	0.47	0.54	0.45

Twelve-month periods ended December 31	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 \$CA7.82 (\$CA7.37 in 2002).

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

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 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 offerings paid by the Company in the amount of approximately \$319,000 (\$220,000 net of income taxes) were recorded as 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 CCRA'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 proceeds from 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 11 for a description of the Canada Customs and Revenue Agency ("CCRA") 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 tax 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) CCRA's Tax Audit

During 2002, the Company received a proposal for reassessment from the CCRA covering the Company's 1996 to 1999 taxation years, which it accepted. Through this proposal, the CCRA disallowed treatment of certain expenses deducted by the Company. Expenses disallowed by the CCRA were mostly related to the 1996 re-capitalization transaction. The Company estimated that the total amount in 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 CCRA. 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

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003	2002	2003	2002
	\$	\$	\$	\$
a) Changes in non-cash operating working capital items				
Accounts receivable - trade	(22,886)	(5,369)	(23,861)	(13,849)
Accounts receivable - other	(1,574)	905	(1,525)	59
Inventories	9,409	15,109	(9,954)	(2,460)
Prepaid expenses	(1,726)	(1,029)	(2,049)	(1,111)
Accounts payable and accrued liabilities	(4,468)	(14,568)	19,902	6,267
Income taxes	5,127	6,752	(3,834)	5,278
Foreign currency translation relating to working capital items	1,797	2,802	4,773	(1,780)
	(14,321)	(4,602)	(16,548)	(7,596)

b) Supplementary information:

Interest paid	161	1,247	1,626	5,216
Income taxes paid	1,331	722	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 exchange contracts		Notional amount	Average exchange rate	Maturing up to	Notional equivalent \$US	Fair market value including notional equivalent \$US
2003	Sell - \$US to \$CAN	33,000	1.5968	December 2004	32,000	39,122
	Sell - Euro to \$US	48,500	1.1275	December 2005	54,684	49,470
	Sell - Euro to \$CAN	6,000	1.6489	December 2004	7,655	7,736
	Sell - GBP to \$US	12,000	1.6686	December 2005	20,023	19,289
2002	Sell - \$US to \$CAN	77,500	1.5887	December 2004	77,500	77,583
	Sell - Euro to \$US	18,400	1.0074	December 2004	18,537	17,933
	Sell - Euro to \$CAN	6,000	1.6489	December 2004	6,180	6,153

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 from 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. If leave is refused, this is the end of the matter. 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

- 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 \$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:

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2003	2002	2003	2002
	\$	\$	\$	\$
Canada	8,127	6,456	16,642	13,445
United States	56,569	59,840	121,399	118,715
International	27,398	14,580	81,650	56,647
	92,094	80,876	219,691	188,807

Capital assets by geographic area 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.