



# Q4

## Quarterly Report

Fourth quarter ended December 31, 2004

### Stock Exchange

Toronto Stock Exchange: MB

### Shares Outstanding

(as at December 31, 2004)

27,292,469 Common Shares

### Fourth Quarter Fiscal 2004 Trading History

TSX	(CA\$)
High:	\$ 19.42
Low:	\$ 17.45
Close:	\$ 19.05
Average volume:	43,616

### Transfer Agent

CIBC Mellon Trust Company  
1.800.387.0825

### Financial Highlights

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

	<u>Q4 2004</u>	<u>Q4 2003</u>
Net sales	<b>\$ 92.3</b>	\$ 92.1
Earnings from operations	<b>\$ 14.4</b>	\$ 22.4
Net earnings	<b>\$ 11.5</b>	\$ 16.3
Earnings per share		
- Basic	<b>\$ 0.42</b>	\$ 0.60
- Diluted	<b>\$ 0.39</b>	\$ 0.55
Earnings per share excluding unusual items		
- Basic	<b>\$ 0.54</b>	\$ 0.60
- Diluted	<b>\$ 0.52</b>	\$ 0.55

### Investor Relations

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## Results of operations

The following table presents a summary of certain selected consolidated financial information on a comparable basis to the same period of the previous year:

	Three-month periods ended December 31,				Twelve-month periods ended December 31,			
	2004		2003		2004		2003	
(U.S. \$ thousands, except per share data)	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales
<b>Earnings Data</b>								
Net sales	<b>92,323</b>	<b>100.0%</b>	92,094	100.0%	<b>234,581</b>	<b>100.0%</b>	219,691	100.0%
Cost of sales	<b>51,002</b>	<b>55.2%</b>	49,542	53.8%	<b>128,659</b>	<b>54.8%</b>	117,244	53.4%
Gross profit	<b>41,321</b>	<b>44.8%</b>	42,552	46.2%	<b>105,922</b>	<b>45.2%</b>	102,447	46.6%
Marketing, research and development and advertising expenses	<b>12,695</b>	<b>13.8%</b>	10,659	11.6%	<b>33,360</b>	<b>14.2%</b>	28,161	12.8%
Other selling, distribution and administrative expenses	<b>9,051</b>	<b>9.8%</b>	9,491	10.3%	<b>34,127</b>	<b>14.5%</b>	31,014	14.1%
Unusual Items	<b>5,158</b>	<b>5.6%</b>	–	0.0%	<b>5,158</b>	<b>2.2%</b>	–	0.0%
Earnings from operations	<b>14,417</b>	<b>15.6%</b>	22,402	24.3%	<b>33,277</b>	<b>14.2%</b>	43,272	19.7%
Interest expense	<b>333</b>	<b>0.4%</b>	265	0.3%	<b>1,377</b>	<b>0.6%</b>	1,802	0.8%
Earnings before income taxes	<b>14,084</b>	<b>15.3%</b>	22,137	24.0%	<b>31,900</b>	<b>13.6%</b>	41,470	18.9%
Income taxes	<b>2,597</b>	<b>2.8%</b>	5,840	6.3%	<b>6,723</b>	<b>3.0%</b>	12,665	5.8%
Net earnings	<b>11,487</b>	<b>12.4%</b>	16,297	17.7%	<b>25,177</b>	<b>10.7%</b>	28,805	13.1%
Earnings per share								
Basic	<b>0.42</b>		0.60		<b>0.93</b>		1.07	
Diluted	<b>0.39</b>		0.55		<b>0.86</b>		0.98	
Earnings per share excluding unusual items								
Basic	<b>0.54</b>		0.60		<b>1.06</b>		1.07	
Diluted	<b>0.52</b>		0.55		<b>0.98</b>		0.98	
Weighted average number of outstanding shares								
Basic	<b>27,253,334</b>		27,117,037		<b>27,185,175</b>		26,992,767	
Diluted	<b>29,211,628</b>		29,557,515		<b>29,331,615</b>		29,437,062	



The following tables present a summary of selected consolidated balance sheet data as at December 31 and Canadian dollar data for the three-month and twelve-month periods ended December 31:

	As at December 31,	
(U.S. \$ thousands)	2004	2003
<b>Balance Sheet Data</b>		
Working capital <sup>(1)</sup>	\$ 101,092	\$ 86,179
Capital assets	32,221	33,510
Total assets	183,155	164,718
Total debt	24,572	36,444

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
(Canadian \$ thousands, except per share data)	2004	2003	2004	2003
<b>Canadian Dollar Data <sup>(2)</sup></b>				
Net sales	\$ 111,120	\$ 110,844	\$ 282,342	\$ 264,420
Net earnings	13,826	19,615	30,303	34,670
Earnings per share				
Basic	\$ 0.51	\$ 0.72	\$ 1.12	\$ 1.28
Diluted	\$ 0.47	\$ 0.66	\$ 1.03	\$ 1.18
Earnings per share excluding unusual items				
Basic	\$ 0.65	\$ 0.72	\$ 1.27	\$ 1.28
Diluted	\$ 0.63	\$ 0.66	\$ 1.18	\$ 1.18

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

<sup>(2)</sup> U.S. dollar financial data is converted into Canadian dollars at the exchange rate of CA\$1.2036 per US\$1.00, as at the December 31, 2004, 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,	
	2004 (Unaudited)	2003 (Unaudited)	2004 (Audited)	2003 (Audited)
<b>Net sales</b>	\$ 92,323	\$ 92,094	\$ 234,581	\$ 219,691
Cost of sales	51,002	49,542	128,659	117,244
Gross profit	41,321	42,552	105,922	102,447
Marketing, research and development and advertising expenses	12,695	10,659	33,360	28,161
Other selling, distribution and administrative expenses	9,051	9,491	34,127	31,014
Unusual items (Note 10)	5,158	–	5,158	–
Earnings from operations	14,417	22,402	33,277	43,272
Interest expense				
Long-term debt	352	268	1,207	1,666
Other	(19)	(3)	170	136
	333	265	1,377	1,802
Earnings before income taxes	14,084	22,137	31,900	41,470
Income taxes (Note 11)				
Current	3,844	5,531	7,427	10,123
Future	(1,247)	309	(704)	2,542
	2,597	5,840	6,723	12,665
<b>Net earnings</b>	\$ 11,487	\$ 16,297	\$ 25,177	\$ 28,805
<b>Earnings per share (Note 8)</b>				
Basic	\$ 0.42	\$ 0.60	\$ 0.93	\$ 1.07
Diluted	\$ 0.39	\$ 0.55	\$ 0.86	\$ 0.98



## Consolidated statements of deficit

(in thousands of U.S. dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2004 (Unaudited)	2003 (Unaudited)	2004 (Audited)	2003 (Audited)
<b>Balance, beginning of period</b>	\$ (63,807)	\$ (93,794)	\$ (77,497)	\$ (106,014)
Net earnings	11,487	16,297	25,177	28,805
Related party transaction adjustment (Note 9)	-	-	-	(288)
<b>Balance, end of period</b>	\$ (52,320)	\$ (77,497)	\$ (52,320)	\$ (77,497)

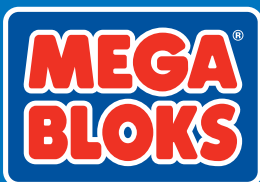


## Consolidated balance sheet

(in thousands of U.S. dollars)

	December 31, 2004 (Audited)	December 31, 2003 (Audited)
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 5,607	\$ 3,595
Accounts receivable - trade	101,984	93,417
Accounts receivable - other	9,898	4,617
Derivative financial instruments (Note 13)	1,184	-
Inventories (Note 3)	26,125	24,440
Income taxes	-	24
Prepaid expenses	4,347	3,823
	<b>149,145</b>	129,916
Capital assets (Note 4)	32,221	33,510
Deferred charges	1,789	1,292
	<b>\$ 183,155</b>	<b>\$ 164,718</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 41,622	\$ 42,782
Derivative financial instruments (Note 13)	4,757	-
Income taxes	1,111	-
Current portion of long-term debt (Note 5)	563	955
	<b>48,053</b>	43,737
Long-term debt (Note 5)	24,009	35,489
Future income taxes (Note 11)	8,294	8,998
	<b>80,356</b>	88,224
<b>Shareholders' equity</b>		
Capital stock (Note 6)	154,434	153,729
Contributed surplus (Note 7)	685	262
Deficit	(52,320)	(77,497)
	<b>102,799</b>	76,494
	<b>\$ 183,155</b>	<b>\$ 164,718</b>

Commitments and contingencies (Note 14)



## Consolidated statements of cash flows

(in thousands of U.S. dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2004 (Unaudited)	2003 (Unaudited)	2004 (Audited)	2003 (Audited)
<b>Cash flows from operating activities</b>				
Net earnings	\$ 11,487	\$ 16,297	\$ 25,177	\$ 28,805
Items not affecting cash and cash equivalents				
Amortization of capital assets	1,585	1,596	8,515	7,305
Amortization of deferred charges	91	90	361	356
Stock-based compensation plan	128	262	423	262
Gain on foreign currency	(1,354)	(1,557)	(3,117)	(4,284)
Future income taxes	(1,247)	309	(704)	2,542
	10,690	16,997	30,655	34,986
Changes in non-cash operating working capital items (Note 12)	(10,709)	(14,484)	(9,362)	(16,548)
	(19)	2,513	21,293	18,438
<b>Cash flows from financing activities</b>				
Repayment of long-term debt	(207)	(135)	(12,940)	(14,201)
Change in revolving credit facility	3,750	(1,500)	1,000	6,000
Issue of capital stock	200	18	705	666
Related party transaction adjustment (Note 9)	—	—	—	(419)
	3,743	(1,617)	(11,235)	(7,954)
<b>Cash flows from investing activities</b>				
Acquisition of capital assets	(24)	(1,607)	(7,201)	(9,765)
Addition of deferred charges	(845)	—	(845)	—
	(869)	(1,607)	(8,046)	(9,765)
Increase (decrease) in cash and cash equivalents	2,855	(711)	2,012	719
Cash and cash equivalents, beginning of period	2,752	4,306	3,595	2,876
<b>Cash and cash equivalents, end of period</b>	<b>\$ 5,607</b>	<b>\$ 3,595</b>	<b>\$ 5,607</b>	<b>\$ 3,595</b>

Supplementary disclosure of cash flow information (Note 12)



## Notes to interim consolidated financial statements

For the three-month and twelve-month periods ended December 31, 2004 and 2003  
(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, net of consideration received from vendors 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 and the following amortization periods:

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

#### *Deferred Charges*

Deferred charges are comprised of financing charges and restructuring costs. Financing charges are recorded at cost and are amortized according to the straight-line method over the term of the credit facility. Restructuring costs are recorded at cost and are amortized according to the straight-line method over 3 years.



## 2. Significant accounting policies (continued)

### *Impairment of Long-Lived Assets*

Long-lived assets are reviewed for impairment by management whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is assessed by comparing the carrying amount of an asset with its expected future net undiscounted cash flows from use together with its residual value (net recoverable value). If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value.

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

### *Research and development expenses*

Research expenses are charged to income net of related tax credits. Unless these expenses meet Canadian generally accepted criteria for deferral, development expenses are charged to income, net of the related tax credits. Research and development expenses are presented net of tax credits of \$1.5 million for the year ended December 31, 2004 (nil for 2003).

### *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 expense items arising from transactions in foreign currencies and from foreign integrated subsidiaries are translated into U.S. dollars at average rates during each reporting period. Gains or losses on foreign exchange are recorded in the consolidated statements of earnings.

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

### *Derivative 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 (continued)

### *Stock-based compensation plans*

The Company uses the fair value method to account for all stock-based compensations. This method requires awards of stock options to be measured on their date of grant using the fair value method. They are expensed and credited to contributed surplus over their vesting period. This credit is reclassified to capital stock when stock options are exercised.

### *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 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 has adopted this Accounting Guideline effective January 1, 2004. Derivative financial instruments used in risk management and qualifying for hedge accounting are recorded using the hedge accounting method described in "Derivative 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 "Net earnings" 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.

In 2004, certain derivative financial instruments ceased to qualify for hedge accounting. A loss of \$3.6 million has been recognized in the results of operations. On February 15, 2005, the Company has decided to unwind these derivative financial instruments that no longer qualify for hedge accounting.

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 adoption of this new Handbook Section did not have a material impact on the consolidated financial statements.

In January 2004, the Emerging Issues Committee of the CICA released Abstract 144 (EIC-144), "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor". EIC-144 specifies the accounting methods to be applied to certain consideration received from a vendor. EIC-144 should be applied retroactively to all financial statements for annual and interim periods ending after August 15, 2004. EIC-144 stipulates that cash consideration received by a company from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should therefore be accounted for as a reduction of cost of goods sold and related inventory when recognized in the Company's income statement and balance sheet. The Company applied retroactively this new recommendation on January 1, 2004. The adoption did not have an impact on the consolidated financial statements.



### 3. Inventories

	2004	2003
	\$	\$
Raw materials	1,797	551
Work in progress	6,368	9,467
Finished goods	17,960	14,422
	<b>26,125</b>	<b>24,440</b>

### 4. Capital assets

	2004		
	Cost	Accumulated amortization	Net book value
	\$	\$	\$
Machinery and equipment	61,183	36,108	25,075
Computer equipment	5,335	3,280	2,055
Leasehold improvements	4,876	1,128	3,748
Machinery and equipment held under capital leases	1,472	382	1,090
Computer equipment held under capital leases	1,480	1,227	253
	<b>74,346</b>	<b>42,125</b>	<b>32,221</b>

	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
	<b>67,091</b>	<b>33,581</b>	<b>33,510</b>



## 5. Long-term debt

On June 30, 2004, the Company amended its Credit Agreement a bearing formal date of May 1, 2002. Through this amended Agreement, the Company and its lenders amended certain provisions of the Credit Agreement. First, the Company repaid \$12.0 million of the term loan. The term loan was for an original amount of \$25.0 million, of which 95% was payable at maturity in 2008. In addition, the Company increased its revolving credit facility to \$57.5 million from \$45.0 million. Strong free cash flow generated in 2003 and during the first six months of fiscal 2004 enabled the Company to repay approximately 50% of its term loan.

	2004	2003
	\$	\$
Term loan, secured, maturing in May 2008 <sup>(1)</sup>	12,375	24,625
Revolving credit facility, secured, the revolving period of which matures in May 2007 <sup>(2)</sup>	11,000	10,000
Obligations under capital leases maturing at various dates up to May 2008 <sup>(3)</sup>	1,197	1,767
Loans, secured, maturing at various dates up to June 2004 <sup>(4)</sup>	—	52
	<b>24,572</b>	<b>36,444</b>
Current portion	563	955
	<b>24,009</b>	<b>35,489</b>

<sup>(1)</sup> Bearing interest at a floating rate based on U.S. Base Rate plus 0.50% to 2.00% or LIBOR rate plus 1.50% to 3.00%, at the option of the Company, of which \$11,750 is repayable at maturity, secured by a moveable hypothec on all assets of the Company. (As at December 31, 2003, 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 repayable at maturity, secured by a moveable hypothec on all assets of the Company.)

<sup>(2)</sup> Bearing interest at a floating rate based on U.S. Base Rate plus 0.25% to 1.75% or LIBOR rate plus 1.25% to 2.75%, at the option of the Company, secured by a moveable hypothec on all assets of the Company. (As at December 31, 2003, 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.)

<sup>(3)</sup> Obligations denominated in Canadian dollars (\$1.4 million), bearing interest at rates ranging between 5.82% and 10.57%.

<sup>(4)</sup> 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.

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 four years on the long-term debt are as follows:

Years	Obligations under capital leases			Other debt	Total
	Minimum payments	Interest	Principal	Principal	principal repayments
	\$	\$	\$	\$	\$
2005	385	72	313	250	563
2006	366	49	317	250	567
2007	405	27	378	11,125	11,503
2008	193	4	189	11,750	11,939
	1,349	152	1,197	23,375	24,572



## 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

	2004		2003	
	Share	Book value \$	Shares	Book value \$
<b>Common shares</b>				
Balance, beginning of year	27,119,532	153,729	26,881,061	153,063
Issued pursuant to exercise of stock options	172,937	705	238,471	666
Balance, end of year	27,292,469	154,434	27,119,532	153,729

## 7. Stock-based compensation plans

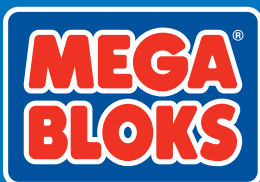
The Company has two stock-based compensation plans whereby options may be granted to officers and other key employees of the Company and its subsidiaries to purchase common shares of the Company.

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.

Immediately prior to the closing of the Initial Public Offering, the Company introduced a New Stock Option Plan. Under this 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, 2004, a total of 5,979,427 common shares (6,152,364 in 2003) 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.

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



## 7. Stock-based compensation plans (continued)

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

	2004		2003	
	Number of options	Weighted average exercise price CA\$	Number of options	Weighted average exercise price CA\$
Options outstanding, beginning of year	3,866,825	8.66	3,925,483	7.76
Granted	98,586	20.72	210,800	20.99
Exercised	(172,937)	5.31	(238,471)	3.99
Forfeited	(89,933)	17.58	(30,987)	14.01
Options outstanding, end of year	3,702,541	8.93	3,866,825	8.66
Options exercisable, end of year	2,765,843	6.40	2,572,239	5.22

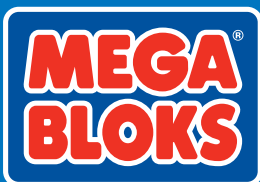
The following table summarizes information about stock options outstanding as at December 31, 2004:

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	2,106,319	4.8	3.85	2,106,319	3.85
14.50 to 25.65	1,596,222	7.6	15.62	659,524	14.53
<b>Total</b>	<b>3,702,541</b>	<b>6.0</b>	<b>8.93</b>	<b>2,765,843</b>	<b>6.40</b>

The fair value of options granted during 2004 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	2004	2003
Risk-free interest rate	4.56%	4.89%
Expected option life	6 years	6 years
Expected volatility	27%	27%
Expected dividends	0%	0%

The weighted average fair value of options granted in 2004 was \$CA7.56 (\$CA7.82 in 2003). The fair value compensation expense recorded to contributed surplus for the year ended December 31, 2004, in respect of these awards was \$0.4 million (\$0.3 million in 2003).



## 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,	
	2004	2003	2004	2003
Numerator for basic and diluted net earnings per common share:				
Net income attributable to common shareholders	\$ 11,487	\$ 16,297	\$ 25,177	\$ 28,805
Denominator for basic net income per common share:				
Weighted average number of common shares outstanding	27,253,334	27,117,037	27,185,175	26,992,797
Basic earnings per share	\$ 0.42	\$ 0.60	\$ 0.93	\$ 1.07
Denominator for diluted net income per common share:				
Weighted average number of common shares outstanding	27,253,334	27,117,037	27,185,175	26,992,797
Plus impact of stock options	1,958,294	2,440,478	2,146,440	2,444,265
Diluted common shares	29,211,628	29,557,515	29,331,615	29,437,062
Diluted earnings per share	\$ 0.39	\$ 0.55	\$ 0.86	\$ 0.98

For the year ended December 31, 2004, 260,553 (205,400 in 2003) outstanding stock options were not included in the computation of diluted earnings per share. With regard 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*

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

	As reported		Pro forma <sup>(1)</sup>	
Three-month periods ended December 31	2004	2003	2004	2003
	\$	\$	\$	\$
Net earnings	11,487	16,297	10,925	15,713
Earnings per share	0.42	0.60	0.40	0.58
Diluted earnings per share	0.39	0.55	0.37	0.53
	As reported		Pro forma <sup>(1)</sup>	
Twelve-month periods ended December 31	2004	2003	2004	2003
	\$	\$	\$	\$
Net earnings	25,177	28,805	22,763	26,437
Earnings per share	0.93	1.07	0.84	0.98
Diluted earnings per share	0.86	0.98	0.78	0.90

<sup>(1)</sup> 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.



## 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.

### *Other*

During the year, consulting fees in the amount of \$153,000 (\$307,000 in 2003) were charged by certain shareholders of the Company. These transactions were carried out in the normal course of business.

## 10. Unusual items

	2004	2003
	\$	\$
Derivative financial instruments <sup>(1)</sup>	3,573	–
Opening new sales market <sup>(2)</sup>	1,585	–
	5,158	–

<sup>(1)</sup> In 2004, certain derivative financial instruments ceased to qualify for hedge accounting. A loss of \$3.6 million has been recognized in the results of operations. On February 15, 2005, the Company has decided to unwind these derivative financial instruments that no longer qualify for hedge accounting.

<sup>(2)</sup> An amount of \$1.6 million was incurred in connection with professional and consulting services related to the expansion of the Company's presence in the German market.



## 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:

	2004	2003
	\$	\$
Income tax expense at statutory rate	7,551	13,463
Manufacturing tax credit	–	(519)
Non-deductible items	159	147
Unrealized gain (loss) on foreign exchange currency	27	(980)
Other	(1,014)	554
Income tax expense	<b>6,723</b>	12,665

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

	2004	2003
	\$	\$
Future income tax assets		
Share issue costs	1,101	1,516
Unrealized portion of foreign exchange loss	942	–
Other	748	406
	<b>2,791</b>	1,922
Future income tax liabilities		
Capital assets	8,210	7,657
Unrealized portion of foreign exchange gain	–	971
Other	2,875	2,292
	<b>11,085</b>	10,920
Future income taxes, net	<b>(8,294)</b>	(8,998)

## 12. Statement of cash flows

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2004	2003	2004	2003
	\$	\$	\$	\$

a) Changes in non-cash operating working capital items

Accounts receivable - trade	(18,780)	(22,886)	(8,567)	(23,861)
Accounts receivable - other	(5,301)	(1,574)	(5,281)	(1,525)
Inventories	15,764	9,409	(1,685)	(9,954)
Prepaid expenses	(954)	(1,726)	(524)	(2,049)
Accounts payable and accrued liabilities	(2,678)	(4,468)	(1,160)	19,902
Income taxes	(3,712)	(5,127)	1,135	(3,834)
Foreign currency translation relating to working capital items	4,952	1,634	6,720	4,773
	<b>(10,709)</b>	(14,484)	<b>(9,362)</b>	(16,548)

b) Supplementary information:

Interest paid	293	161	1,363	1,626
Income taxes paid	4,118	1,331	6,288	12,376



## 12. Statement of cash flows (continued)

c) During the year, capital assets were acquired at an aggregate cost of \$7,226,000 (\$10,497,000 in 2003) of which \$25,000 (\$732,000 in 2003) was acquired by means of capital leases. Capital assets acquired in 2004 are netted from a government grant of \$855,000 (\$214,000 in 2003).

## 13. Derivative 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, 2004 and 2003:

Foreign exchange contracts	Notional amount \$	Average exchange rate	Maturing up to	Notional equivalent US \$	Fair market value US \$
<b>2004 - No longer qualifying for hedge accounting</b>					
- \$US to \$CA	9,000	1.3600	Feb. 2006	9,000	1,184
- EUR to \$US	16,500	1.1670	Dec. 2005	19,256	(3,133)
- GBP to \$US	7,750	1.6859	Dec. 2005	13,066	(1,624)
<b>2004 - Qualifying for hedge accounting</b>					
- EUR to \$US	16,000	1.2207	Dec. 2006	19,532	(2,280)
- GBP to \$US	6,000	1.7820	Dec. 2006	10,692	(622)
<b>2003 - Qualifying for hedge accounting</b>					
- \$US to \$CA	32,000	1.5968	Dec. 2004	32,000	7,122
- EUR to \$US	48,500	1.1275	Dec. 2005	54,684	(5,214)
- EUR to \$CA	6,000	1.6489	Dec. 2004	7,655	81
- GBP to \$US	12,000	1.6686	Dec. 2005	20,023	(735)

### *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.



### 13. Financial instruments (continued)

#### *Fair value*

The Company has determined that the carrying value of its short-term financial assets and liabilities other than derivative financial instruments above 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 April 29, 2004, the Supreme Court of Canada granted Kirkbi AG and Lego Canada Inc. ("Lego") leave to present an appeal to the Court from a July 14, 2003 decision of the Federal Court of Appeal. The appeal will be heard on March 16, 2005. Lego's action, which was dismissed by the Federal Court Trial Division and the Federal Court of Appeal, claims that Lego has the exclusive right to the "look" of the knobs of stackable, interlocking toy blocks marketed by both Lego and Mega Bloks.
- 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 \$26,392,000. The minimum annual rent payable (excluding certain occupancy charges) for each of the next five years, is as follows:

	\$
2005	3,824
2006	3,818
2007	4,001
2008	4,075
2009	4,122

- d) In connection with an agreement with Investissement Québec, an aggregate amount of CA\$3,900,000 was granted to the Company over a period of three years. This grant was 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 \$855,000 to acquire certain capital assets which was accounted for as a reduction of capital assets.

During 2001, 2002, and 2003, the Company received grants in an amount of \$1,856,000 to acquire certain capital assets and to create employment. 61% of the grants received in 2001, 2002, and 2003 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, 2004, the Company had outstanding letters of guarantee in the amount of \$1,246,000 (\$1,364,000 in 2003) 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 \$49.4 million (\$50.1 million in 2003) and \$47.5 million (\$35.9 million in 2003).

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,	
	2004	2003	2004	2003
	\$	\$	\$	\$
Canada	9,964	8,127	20,289	16,642
United States	46,286	56,569	112,455	121,399
International	36,073	27,398	101,837	81,650
	92,323	92,094	234,581	219,691

*Capital assets by geographic area are as follows:*

	2004	2003
Canada	31,721	33,290
International	500	220
	32,221	30,510

## 16. Comparative figures

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