Management Discussion and Analysis

Business Review

Turnover and gross profit margin

Turnover grew 25.8% during the year under review compared with that of 2004, lifted by a strong U.S. consumer market. Gross profit margin fell from 14.8% in the year ended 31 December 2004 to 11.6% during the same period in 2005 which was mainly caused by rising raw material costs, wages and other operating expenses in Mainland China. Although it is the practice of the Group to negotiate pricing with customers on a cost-plus basis, most of the Group's orders secured during the first half year were confirmed before the announcement of an increase of 27.5% in the minimum wage in Zhongshan Shi, which went into effect on 1 March 2005. Therefore the gross profit margin attained in the first half year was only 9.6%. The gross profit margin improved to 13.3% in the second half year following some adjustments in pricing to reflect the wage increase. Operating costs also rose during the year under review because the Group offered additional fringe benefits to its employees in order to maintain a steady, skilled labor force amid the current labor shortages in Guangdong Province. Furthermore, the appreciation of Renminbi against Hong Kong dollar during the year had resulted in higher production costs of the Group as substantial production expenses were paid in Renminbi whereas the operating income was received in Hong Kong dollar and the United States dollar. The combined effect of these factors had resulted in the decrease of gross profit margin from 14.8% in 2004 to 11.6% in 2005.

With the change in market demand for hard toys and stuffed toys, sales of hard toys and stuffed toys for the year ended 31 December 2005 contributed 83.8% (2004: 87.0%) and 16.2% (2004: 13.0%) respectively to the Group's turnover.

Geographically, USA and Canada remained the major market where 85.0% (2004: 83.7%) of the Group's turnover was generated. The balances of 13.2% (2004: 12.7%) and 1.8% (2004: 3.6%) were attributable to sales to Japan & others, and Hong Kong & Mainland China.

Expenses

During the year under review, selling and distribution costs amounted to HK$19,568,000 (2004: HK$15,827,000) and the increase was mainly attributable to the increase in the Group's turnover. In terms of the Group's turnover, the selling and distribution costs remained relatively stable for the years ended 31 December 2005 (3.5%) and 2004 (3.5%).

Administrative expenses amounted to HK$43,753,000 (2004: HK$35,642,000) for the year ended 31 December 2005. The increase was partially due to professional fees incurred for the review of the Group's internal controls procedures and the increase in operating expenses as a result of the appreciation of Renminbi.

Other operating income of HK$236,000 for the year ended 31 December 2005 was attributable to the net gain on disposal of items of property, plant and equipment.

Management Discussion and Analysis

Business Review (continued)

Investigation by Independent Commission Against Corruption (the "ICAC Investigation")

In June 2005, certain senior executives and directors of the Group, including the then Chairman of the Board of the Company and an executive director of the Company, were arrested by the Independent Commission Against Corruption and were alleged to have solicited illegal rebates from certain suppliers for placing purchase orders with them between the years 2002 and 2004. The ICAC Investigation is currently underway. Despite the lack of further information relating to the ICAC Investigation, the Board has taken a series of measures to minimise any possible impact or uncertainties that might be caused by the ICAC Investigation and to safeguard the interests of the Group, its shareholders and customers by way of changes of certain directorships and to implement new measures to further enhance the effectiveness of the Group's internal control system. Further details of these changes and the new measures implemented were disclosed in the announcements dated 6 July 2005 and 26 January 2006.

Liquidity and Financial Resources

The Group is financing its operations from internally generated cashflow. As at 31 December 2005, cash and bank deposits held by the Group, mainly in Hong Kong dollar, the United States dollar and Renminbi, amounted to approximately HK$34,057,000 (2004: HK$19,462,000). The Group's current ratio (current assets/current liabilities) and gearing ratio (total bank borrowings/total shareholders' equity) were 2.2 (2004: 1.9) and 0% (2004: 6.5%), respectively.

Except for the acquisition of additional 20% interest in associates, which amounts to HK$1,560,000, in 2006, the Group did not expect to incur material capital expenditure in the coming year. Therefore the Board believes that the existing financial resources will be sufficient to satisfy its future operational needs and capital commitments.

Contingent Liabilities

The Group had a contingent liability in respect of possible future long service payments to employees under the Hong Kong Employment Ordinance, with a maximum possible amount of HK$1,386,000 as at 31 December 2005 (2004: HK$613,000). The contingent liability has arisen at the balance sheet date as a number of current employees have achieved the required number of years of service to the Group, and will be eligible for long service payments under the Employment Ordinance if their employment is terminated under certain circumstances. A provision has not been recognised in respect of such possible payments, as it is not considered probable that the situation will result in a material future outflow of resources from the Group.

Management Discussion and Analysis

Contingent Liabilities (continued)

At the balance sheet date, the Company had provided corporate guarantees of HK$500,000 (2004: HK$500,000) to a bank in respect of banking facilities granted to one of its associates. At the same date, such banking facilities were utilised by the associate up to an amount of HK$500,000 (2004: HK$463,000).

Charge on Assets

As at 31 December 2005, certain of the Group's buildings with a net book value of HK$24,251,000 (2004: Nil) were pledged to secure general banking facilities granted to the Group. As at 31 December 2005, such facilities were not utilised.

Exchange Risk

The Group has transactional currency exposures. Such exposures arise from sales or purchases by operating units in currencies other than the units' functional currency. Approximately 44.4% (2004: 52.0%) of the Group's sales are denominated in currencies other than the functional currency of the operating units making the sale, which is mainly the United States dollar, whilst almost 28.5% (2004: 34.7%) of costs are denominated in the functional currency. As the major foreign currency sales is denominated in the United States dollar and major foreign currency costs in Renminbi, the currency exposures are limited and it is the Group's policy not to enter into forward contracts until a firm commitment is in place.

Employees

As at 31 December 2005, the Group had a total of approximately 8,900 (31 December 2004: 8,970) employees in Hong Kong and Mainland China. The Group provides remuneration packages to employees largely based on industry practice, individual performance, qualification and experience. In addition, discretionary bonuses and share options under the Company's share options scheme may be granted to eligible staff by reference to the Group's performance and individual performance. The Group also provides subsidies to staff for external training in order to enhance the Group's competitive edge.