

**ALLIANCE DISTRIBUTORS HOLDING INC.  
INDEX TO FINANCIAL STATEMENTS**

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### INDEPENDENT AUDITORS' REPORT

The Stockholders  
Alliance Distributors Holding Inc.

We have audited the accompanying balance sheet of Alliance Distributors Holding Inc. as of December 31, 2008, and the related statements of operations, stockholders' equity and cash flows for the year 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 audit. The financial statements of Alliance Distributors Holding Inc. as of and for the year ended December 31, 2007, were audited by other auditors, Mahoney Cohen & Company, CPA, P.C., whose shareholders became shareholders of Mayer Hoffman McCann P.C. as of December 31, 2008, and whose report dated March 27, 2008, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about 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. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Alliance Distributors Holding Inc. as of December 31, 2008, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

*MHM Mahoney Cohen CPAs*

New York, New York  
March 16, 2009

**ALLIANCE DISTRIBUTORS HOLDING INC.**  
**BALANCE SHEETS**  
**DECEMBER 31, 2008 AND 2007**  
(In Thousands, except per share amounts)

	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and equivalents	\$ 924	\$ 320
Accounts receivable-net	5,334	6,645
Inventory	7,262	10,322
Due from vendors	342	72
Prepaid expenses and other current assets	215	144
Deferred income taxes	<u>263</u>	<u>141</u>
<b>Total current assets</b>	14,340	17,644
<b>PROPERTY AND EQUIPMENT – NET</b>	501	606
<b>DEFERRED INCOME TAXES</b>	178	77
<b>OTHER ASSETS</b>	<u>88</u>	<u>59</u>
<b>TOTAL</b>	<u>\$15,107</u>	<u>\$18,386</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Notes payable – bank	\$ 6,806	\$ 6,787
Accounts payable	4,630	8,937
Current portion of long term obligations	-	5
Accrued expenses and other current liabilities	<u>425</u>	<u>545</u>
<b>Total current liabilities</b>	<u>11,861</u>	<u>16,274</u>
<b>DEFERRED LEASE OBLIGATIONS</b>	<u>50</u>	<u>50</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Series A Convertible Non-Redeemable Preferred Stock, \$.001 par value; 8,269 and 8,275 shares authorized at December 31, 2008 and 2007, respectively; 6 shares issued and outstanding at December 31, 2007	-	-
Common stock, \$.001 par value; 100,000 shares authorized; 52,883 and 52,785 shares issued and outstanding at December 31, 2008 and 2007, respectively	53	53
Additional paid-in capital	3,662	3,564
Accumulated deficit	<u>(519)</u>	<u>(1,555)</u>
<b>Total stockholders' equity</b>	<u>3,196</u>	<u>2,062</u>
<b>TOTAL</b>	<u>\$15,107</u>	<u>\$18,386</u>

See notes to financial statements



**ALLIANCE DISTRIBUTORS HOLDING INC.**  
**STATEMENT OF STOCKHOLDERS' EQUITY**  
**YEARS ENDED DECEMBER 31, 2008 and 2007**  
(In thousands)

	Preferred Stock		Common Stock		Additional	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid in Capital	Deficit	Stockholders' Equity
Balance, January 1, 2007	262	\$ -	48,721	\$ 49	\$ 3,415	\$ (234)	\$ 3,230
Conversion of Preferred Stock A into Common Stock	(256)	-	4,064	4	(4)		-
Equity compensation expense					153		153
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,321)</u>	<u>(1,321)</u>
Balance, December 31, 2007	6	\$ -	52,785	\$ 53	\$ 3,564	\$ (1,555)	\$ 2,062
Conversion of Preferred Stock A into Common Stock	(6)	-	98	-	-	-	-
Equity compensation expense					98		98
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,036</u>	<u>1,036</u>
Balance, December 31, 2008	<u>-</u>	<u>\$ -</u>	<u>52,883</u>	<u>\$ 53</u>	<u>\$ 3,662</u>	<u>\$ (519)</u>	<u>\$ 3,196</u>

See notes to financial statements

**ALLIANCE DISTRIBUTORS HOLDING INC.**  
**STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2008 AND 2007**  
(In thousands)

	<u>2008</u>	<u>2007</u>
<b>OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 1,036	\$ (1,321)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	204	210
Provision for doubtful accounts	115	55
Loss on disposal of assets	-	26
Equity compensation expense	98	153
Amortization of deferred financing costs	56	103
Deferred rent	-	10
Deferred income taxes	(223)	-
Changes in operating assets and liabilities:		
Accounts receivable	1,196	1,222
Inventory	3,060	(1,218)
Due from vendors	(270)	11
Prepaid expenses and other assets	(111)	10
Accounts payable	(4,307)	405
Accrued expenses and other current liabilities	<u>(120)</u>	<u>446</u>
Net cash provided by operating activities	<u>734</u>	<u>112</u>
<b>INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(99)	(90)
Proceeds from insurance claim	<u>-</u>	<u>401</u>
Net cash (used in) provided by investing activities	<u>(99)</u>	<u>311</u>
<b>FINANCING ACTIVITIES:</b>		
Proceeds from note payable, net of repayments – bank	19	-
Repayments of note payable, net of proceeds – bank	-	(414)
Payment of long-term obligations	(5)	(10)
Payment of deferred financing costs	<u>(45)</u>	<u>(25)</u>
Net cash used in financing activities	<u>(31)</u>	<u>(449)</u>
<b>INCREASE (DECREASE) IN CASH AND EQUIVALENTS</b>	604	(26)
<b>CASH AND EQUIVALENTS, BEGINNING OF YEAR</b>	<u>320</u>	<u>346</u>
<b>CASH AND EQUIVALENTS, END OF YEAR</b>	<u>\$ 924</u>	<u>\$ 320</u>

See notes to financial statements

**ALLIANCE DISTRIBUTORS HOLDING INC.**  
**Notes to Financial Statements**

**Note 1 - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Alliance Distributors Holding Inc. (the "Company" or "Alliance") is a distributor of video game consoles, peripherals, accessories and software to customers throughout the United States for most key manufacturers and third party publishers in the video game industry. The Company operates as a single segment.

**Basis of Presentation and Use of Estimates**

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates reflected in these financial statements relate primarily to bad debt reserves on accounts receivable, inventory valuation and the realization of deferred tax assets.

Certain 2007 amounts have been reclassified to conform to the 2008 presentation. This reclassification includes an increase in 2007 cost of goods sold and a corresponding decrease in operating costs and expenses.

**Allowance for Doubtful Accounts**

The Company establishes credit terms for new clients based upon management's review of their credit information and projects terms, performs ongoing credit evaluations of its customers, adjusting credit terms when management believes appropriate based upon payment history and an assessment of their current credit worthiness. The Company records an allowance for doubtful accounts for estimated losses resulting from the inability of its clients to make required payments. The Company determines this allowance by considering a number of factors, including the length of time trade accounts receivable are past due, previous loss history, estimate of the client's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. While credit losses have generally been within expectations and the provisions established, the Company cannot guarantee that credit loss rates in the future will be consistent with those experienced in the past. In addition, the Company has credit exposure if the financial condition of one of its major clients were to deteriorate. In the event that the financial condition of its clients were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be necessary. It is reasonably possible that the Company's estimate of the allowance for doubtful accounts will change. As of December 31, 2008 and 2007, the Company's allowance for doubtful accounts totaled approximately \$205,000 and \$362,000, respectively.

**Inventory**

Inventory consists entirely of finished goods held for sale and is reported at the lower of cost or market, on the average cost basis. The Company receives price protection from certain of its suppliers for merchandise that may be slow moving or aged. The Company evaluates the adequacy of its slow moving or aged inventory quarterly and writes down its inventory to fair value based upon the price protection received or current market value. While write-downs have been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same level of write-downs as in the past. At times, the Company makes advance payments to vendors to procure and ensure delivery of certain high demand products. Such deposits are reflected as due from vendors in the balance sheet. The Company does not offer warranties to its customers but will accept returns of product claimed to be defective and reimburse the customers for the purchase price paid. The majority of the Company's suppliers in turn accept these returns by customers. There are no reserves for warranties as of December 31, 2008 and 2007.

**Property and Equipment**

Property and equipment is recorded at cost. Expenditures for major additions and improvements are capitalized and minor replacements, maintenance and repairs are charged to expense as incurred. Assets held under capital leases are recorded at the lower of the net present value of the minimum lease payments or the fair value of the leased assets at the inception of the lease. Leasehold improvements are amortized over the lesser of the lease terms or the assets' useful lives.

When property and equipment is retired or otherwise disposed of, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the results of operations for the respective period. Depreciation and amortization is provided over the estimated lives of the related assets using the straight-line method. The estimated useful lives for significant property and equipment categories are as follows:

Vehicles	4 years
Warehouse equipment	3 to 7 years
Office furniture and equipment	2 to 7 years
Leasehold improvements	up to 5 years
Computer software	2 to 3 years

### **Impairment of Long-Lived Assets**

The Company follows Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 requires that long-lived assets, including property and equipment, be reviewed for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. The Company assesses its assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the asset and records impairment losses when this amount is less than the carrying amount. Impairment losses are recorded for the excess of the assets' carrying amount over their fair value, which is generally determined based on the estimated future discounted cash flows over the remaining useful life of the asset using a discount rate determined by management at the date of the impairment review. Management believes at this time that the carrying value and useful life of long-lived assets continue to be appropriate.

### **Deferred Rent**

The Company accounts for scheduled rent increases contained in its leases on a straight-line basis over the non-cancellable lease term.

### **Revenue Recognition**

The Company recognizes sales upon shipment of products to customers as title and risk of loss pass upon shipment and collectibility is reasonably assured. Provisions for estimated discounts and rebates to customers, estimated returns and allowances and other adjustments are provided for in the same period the related sales are recorded. The Company presents revenues net of any taxes collected from customers.

### **Income Taxes**

The Company accounts for income taxes using the liability method which requires the recognition of deferred tax assets or liabilities for the temporary differences between the financial reporting and tax bases of the Company's assets and liabilities and for tax carry forwards at enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. In addition, valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes" on January 1, 2007. FIN 48 requires companies to determine whether it is "more likely than not" that a tax position will be sustained upon examination by the appropriate taxing authorities before any tax benefit can be recorded in the financial statements. It also provides guidance on the recognition, measurement, classification and disclosure in the financial statements for uncertain tax positions taken or expected to be taken in a tax return. No cumulative effect of a change in accounting principle or adjustment to the liability for unrecognized tax benefits was recognized as a result of the adoption of FIN 48. Accordingly, the adoption of FIN 48 did not have an effect on the results of operations or financial position of the Company.

As of December 31, 2008 and 2007, there are no unrecognized tax benefits, and there have been no income tax related interest or penalties accrued in the years ended December 31, 2008 and 2007. If and when applicable, the Company will report interest expense and penalties related to income tax liabilities as a component of its provision for income taxes. Tax years commencing June 29, 2004, the date the Company became taxed as a C Corporation, are subject to tax examination.

## **Operating costs and expenses**

The Company includes shipping and handling costs in operating costs and expenses. For the years ended December 31, 2008 and 2007, the Company incurred approximately \$1,228,000 and \$883,000 of such costs, respectively.

Advertising expenses are charged to operations in the period in which they are incurred.

## **Fair Value of Financial Instruments**

The carrying amounts of significant financial instruments, which include accounts receivable, accounts payable and accrued expenses, approximated fair value as of December 31, 2008 and 2007 due to their short-term maturities. Borrowings under the financing agreement approximate fair value due to their variable interest rate.

Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), for financial assets and liabilities carried at fair value. This pronouncement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company's adoption of SFAS 157 did not have a material effect on the Company's financial statements for financial assets and liabilities. In accordance with FASB Staff Position No. FAS 157-2 ("FSP 157-2"), the Company elected to defer until January 1, 2009 the adoption of SFAS 157 for all non-financial assets and liabilities that are not recognized or disclosed at fair value in the financial statements. The Company does not believe that the adoption of FSP 157-2 will have a material impact on the financial statements. In October 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. FAS 157-3, "Determining the Fair Value of a Financial Asset in a Market That Is Not Active" ("FSP 157-3"), which clarifies the application of SFAS 157 when the market for a financial asset is inactive. The guidance in FSP 157-3 is effective immediately and did not have a material effect on the Company's financial statements.

Effective January 1, 2008, the Company adopted SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), which expands opportunities to use fair value measurements in financial reporting and permits entities to choose to measure many financial instruments and certain other items at fair value. Under SFAS 159, entities that elect the fair value option (by instrument) will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option election is irrevocable, unless a new election date occurs. The Company chose not to elect the fair value option for its financial assets and liabilities existing at January 1, 2008, and did not elect the fair value option on financial assets and liabilities transacted in 2008. Therefore, the adoption of SFAS 159 had no impact on the Company's financial statements.

## **Net Income (Loss) Per Share**

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing income (loss) available to common shareholders by the weighted-average number of common shares outstanding during the period increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The dilutive effect of the outstanding options is reflected in diluted earnings (loss) per share by application of the treasury stock method. For the year ended December 31, 2008, basic and diluted weighted-average shares outstanding include the vested portion of restricted shares that were rescinded on December 31, 2008 (Note 8). For the year ended December 31, 2008, the dilutive effect of outstanding stock options and warrants totaled approximately 484,000 shares. Diluted net loss per share for 2007 does not include potential common shares derived from stock options because as a result of the Company incurring losses, their effect would have been anti-dilutive.

Options to purchase 4.3 million and 4.6 million shares of common stock in the years ended December 31, 2008 and 2007, respectively, were outstanding but not included in the computation of diluted income per share because the options' exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive. In addition, common stock equivalents for the year ended December 2007 exclude approximately 182,000 for common shares issuable upon exercise of warrants and approximately 99,000 common shares issuable upon conversion of Series A Convertible Non-Redeemable Preferred Stock since their effect would be anti-dilutive.

## Stock Based Compensation

The Company accounts for share based compensation pursuant to Statement of Financial Accounting Standards No. 123(R), "Share Based Payment" ("SFAS No. 123(R)") which requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The Company has adopted the modified prospective method whereby compensation cost is recognized in the financial statements beginning with the effective date based on the requirements of SFAS No. 123(R) for all share-based payments granted after that date and for all unvested awards granted prior to that date.

## Note 2 – SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Supplemental disclosures of cash flow information (in thousands) are as follows:

Cash paid during the year for:	<u>2008</u>	<u>2007</u>
Interest	<u>\$603</u>	<u>\$763</u>
Income taxes	<u>\$ 17</u>	<u>\$ 20</u>

## Note 3 - CONCENTRATIONS OF CREDIT RISK AND MAJOR SUPPLIERS

### Cash and Equivalents

The Company maintains cash balances at various banks. Accounts at each institution are insured by the Federal Deposit Insurance Corporation up to \$250,000. The Company considers highly liquid investments with original maturities of three months or less to be cash equivalents.

### Accounts Receivable and Major Customers

Concentrations of credit risk with respect to accounts receivable are limited because a large number of customers make up the Company's customer base, thus spreading the trade credit risk. The Company controls credit risk through credit approvals, credit limits and monitoring procedures. The Company performs credit evaluations of its customers but generally does not require collateral to support accounts receivable. For the years ended December 31, 2008 and 2007, one customer accounted for approximately 12% and 16%, respectively, of the Company's sales. No other customer accounted for more than 10% of the Company's sales in 2008 and 2007.

### Fluctuations in Operating Results and Seasonality

The Company has experienced fluctuations in its operating results as a result of the timing of the introduction of new titles; variations in sales of titles developed for particular platforms; market acceptance of its titles; sequels or enhancements of existing titles; projected and actual changes in platforms; the timing and success of title introductions by its competitors; product returns; changes in pricing policies by the Company and its competitors; order cancellations; and delays in shipment. Sales of various titles are also seasonal, with peak shipments typically occurring in the fourth calendar quarter as a result of increased demand for titles during the holiday season. Annual comparisons of operating results are not necessarily indicative of future operating results.

### Major Suppliers

For the year ended December 31, 2008, the Company's three largest suppliers in the aggregate accounted for approximately 58% of total purchases (with one accounting for 44% alone) and the ten largest suppliers in the aggregate accounted for approximately 77% of total purchases. For the year ended December 31, 2007, the Company's three largest suppliers in the aggregate accounted for approximately 48% of total purchases (with one accounting for 28% alone) and the ten largest suppliers in the aggregate accounted for approximately 69% of total purchases. At December 31, 2008 and 2007, the amount due to these three suppliers was approximately \$2.1 million and \$4.9 million, respectively, and is included in accounts payable on the accompanying balance sheets. If a significant supplier terminates or modifies its relationship with the Company future results could be materially and adversely affected.

#### Note 4 - PROPERTY AND EQUIPMENT

Property and equipment, stated at cost less accumulated depreciation and amortization (in thousands) consists of the following:

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Leasehold improvements	\$ 403	\$ 403
Computers, office equipment and furniture	367	349
Warehouse equipment	101	92
Vehicles	78	52
Equipment under capital leases	24	24
Software	<u>190</u>	<u>144</u>
Total	1,163	1,064
Less accumulated depreciation and amortization	<u>662</u>	<u>458</u>
	<u>\$ 501</u>	<u>\$ 606</u>

Depreciation and amortization expense approximated \$204,000 and \$210,000 for the years ended December 31, 2008 and 2007, respectively.

#### Note 5 - FINANCING AGREEMENT

Effective May 11, 2007, the Company amended its financing agreement (the "Agreement") with Rosenthal & Rosenthal, Inc. ("Rosenthal"), pursuant to which the maximum credit facility, as defined, was increased from \$10,000,000 to \$15,000,000 (\$17,500,000 from November 1 to January 31 of each year), the interest rate on outstanding borrowings was decreased from the prime rate plus 1.5% to the prime rate plus 0.75% (but in no event shall the prime interest rate used in the computation be less than 4.75%), and the termination date was extended to May 31, 2010. Borrowings under the credit facility are based on eligible inventory and receivables, are due on demand, are secured by substantially all of the assets of the Company and are subject to the Company's compliance with certain financial covenants. In addition, the Company's CEO and the Company's former President have signed limited guaranties in respect of borrowings under the Agreement.

The amended Agreement expires May 31, 2010, unless earlier terminated by Rosenthal on 30 days' notice. At December 31, 2008, the interest rate on borrowings outstanding was 5.5%. In addition, the Company is obligated to pay on each anniversary date an annual fee of 0.25% of the maximum credit facility in effect on such anniversary date which is amortized over one year, as well as a monthly administrative fee of \$1,000. The financing expense for the annual fee recorded totaled approximately \$56,000 and \$85,000 for the years ended December 31, 2008 and 2007, respectively.

In connection with establishing the initial Agreement, the Company issued to Rosenthal a warrant (the "Warrant") to purchase 500,000 shares of common stock at \$0.10 per share. The Warrant expires on November 30, 2010. On notice by the Company the Warrants will expire earlier if the closing price of the common stock during a period designated in the Warrants is not less than \$0.40 per share. The Warrants may be exercised by Rosenthal at \$.10 per share for cash or on a cashless basis (i.e., by deducting from the number of shares otherwise issuable on exercise a number of shares that have a then market value equal to the exercise price). The Company recorded a deferred financing cost of approximately \$60,000 in the fourth quarter 2004, representing the fair value of the warrants, which is amortized over the initial three year life of the financing agreement. The financing expense recorded totaled approximately \$17,000 for the year ended December 31, 2007.

Under the terms of the Agreement, the Company is required to maintain a specified level of net worth, working capital and debt ratios as defined. The Company was in compliance with its covenants at December 31, 2008.

The Company believes that it will have sufficient liquidity for the next twelve months and the foreseeable future. However, the Company would be materially and adversely affected if Rosenthal demands payment of these borrowings under the Agreement and if the Company is unable to refinance these borrowings.

**Note 6 - INCOME TAXES**

The components of the (benefit from) provision for income taxes are as follow (in thousands):

	<u>2008</u>	<u>2007</u>
Current:		
Federal	\$ 100	\$ -
State and local	<u>39</u>	<u>-</u>
	<u>139</u>	<u>-</u>
Deferred:		
Federal	(182)	-
State and local	<u>(41)</u>	<u>-</u>
	<u>(223)</u>	<u>-</u>
Total	<u>\$ (84)</u>	<u>\$ -</u>

The Company's effective income tax rate is lower than what would be expected if the federal statutory rate were applied to income from operations primarily because of the changes in the deferred tax valuation allowance. In 2008, the Company recognized a benefit from the utilization of operating loss carryforwards totaling approximately \$167,000.

Significant components of the Company's net deferred tax assets at December 31, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Net operating loss carryforwards	\$ 2,124	\$ 2,458
Reserves and other items not currently deductible	238	366
Equity compensation not currently deductible	150	141
Expenses not currently deductible	20	126
Costs capitalized to inventory for tax purposes	25	26
Other	<u>8</u>	<u>(15)</u>
	2,565	3,102
Less: valuation allowance	<u>(2,124)</u>	<u>(2,884)</u>
Net deferred tax assets	<u>\$ 441</u>	<u>\$ 218</u>
Net deferred tax asset – current	\$ 263	\$ 141
Net deferred tax asset – non-current	<u>178</u>	<u>77</u>
	<u>\$ 441</u>	<u>\$ 218</u>

At December 31, 2008, the Company had federal and state net operating loss carryforwards (NOL's) of approximately

\$5.5 million. The federal NOL's expire through 2023 and the state NOL's expire through 2016. In assessing the realization of deferred tax assets, management considers whether it is more likely than not that all or some portion of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the generation of future taxable income during the periods in which temporary differences are deductible and net operating losses are utilized. Based on a consideration of these factors, the Company has established a valuation allowance of approximately \$2,124,000 and \$2,884,000 at December 31, 2008 and 2007, respectively, due to the uncertainty surrounding the realization of the NOL's which resulted from a 2004 stock exchange agreement. Pursuant to IRC Section 382 of the Tax Reform Act of 1986 the utilization of NOL's is limited in the case of certain transactions including significant changes in ownership interests. The Company has determined that based upon the terms of a 2004 stock exchange agreement, an ownership change pursuant to this Act had occurred. As a result, the NOL's are significantly limited. The Company considered many factors when assessing the likelihood of future realization of the deferred tax assets, including the Company's recent cumulative earnings experience, expectation of future income, and other relevant factors. Based upon the management's assessment and the available evidence, in 2008, the Company reversed the portion of the valuation allowance previously set up on the portion of deferred tax assets not resulting from the 2004 stock exchange agreement. The \$760,000 decline in valuation allowance in 2008 also resulted from the utilization of Company's post 2004 net operating loss carryforwards, as well as from a decline in the effective tax rate of the pre-2004 NOL carryforwards. The valuation allowance increased by \$550,000 in 2007 primarily resulting from net operation losses incurred for which realization was uncertain. The reversal of the valuation allowance resulted in a tax benefit of approximately \$547,000 in the year ended December 31, 2008.

#### **Note 7 - RETIREMENT PLAN**

The Company sponsors a 401(k) contributory plan (the "Plan") for the benefits of employees who are at least 21 years of age. The Company's management determines, at its discretion, any annual contributions. The Company elected not to contribute to the Plan for the years ended December 31, 2008 and 2007.

#### **Note 8 – STOCK PLANS AND WARRANTS**

##### **Stock Plans**

In 2004, the Company established the 2004 Stock Plan (the "2004 Plan") to grant equity and equity-linked awards up to a maximum of 10,000,000 shares of common stock. In addition, in February 2007, the Company's stockholders approved the 2006 Stock Plan (the "2006 Plan"), which authorizes grants for up to an additional 10,000,000 shares of common stock. The Company has not made any award grants from the 2006 Plan.

Information with respect to stock options pursuant to the 2004 Plan is as follows:

	Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term
Outstanding – January 1, 2008	4,620	\$.322	
Granted	720	\$.222	
Forfeited	<u>(265)</u>	\$.325	
Outstanding – December 31, 2008	5,075	\$.307	6.5 years
Exercisable at December 31, 2008	4,534	\$.317	6.2 years

All of the issued options are ten-year non-qualified stock option grants. In 2008, the Company granted options to purchase 100,000 common shares to each of three independent directors of the Company. Thirty percent of the option grant vested immediately and the remaining seventy percent vest in eight equal quarterly installments. In addition, in 2008 the Company granted options to purchase a total of 420,000 common shares to various employees. These stock options, as well as all previous stock option grants, vest ratably in twelve equal quarterly installments.

Pursuant to the 2004 Stock Plan, in 2008 the Company granted 1 million restricted shares of common stock to its Chief Executive Officer and Chairman of the Board. The shares vested quarterly at a rate of 83,333 shares per quarter. On December 31, 2008, the restricted stock grant was rescinded and the 1 million shares were cancelled.

For the years ended December 31, 2008 and 2007, share-based compensation expense related to the Company's 2004 Stock Plan totaling approximately \$98,000 and \$153,000, respectively, and is included in operating costs and expenses. In addition, at December 31, 2008, total compensation cost related to non-vested stock options not yet recognized totaled approximately \$87,000. This cost is expected to be recognized over a weighted average period of 27 months.

The fair value of the options-pricing model was calculated with the following weighted-average assumptions used for grants during the year ended December 31, 2008: risk-free interest rate 3.6%; expected life 6 years; expected volatility 80%. The fair value generated by the options pricing model may not be indicative of the future benefit, if any, that may be received by the option holder.

The number and weighted-average grant-date fair value of non-vested stock options is as follows:

	Shares (in thousands)	Weighted Average Grant-Date Fair Value
Non-vested – January 1, 2008	58	\$.16
Granted in 2008	720	\$.16
Unvested portion forfeited in 2008	-	
Vested in 2008	<u>(237)</u>	\$.16
Non-vested – December 31, 2008	<u>541</u>	\$.16

Subsequent to December 31, 2008, the Company granted options to purchase 100,000 common shares at an exercise price of \$0.24 per share to an independent director. The stock option has a ten-year term, with 30,000 shares vesting immediately, and the remaining 70,000 shares vesting quarterly at a rate of 8,750 per quarter.

#### **Warrants**

In 2004, the Company issued warrants to purchase 1,564,096 shares of common stock at an exercise price of \$0.22 per share. The warrants expire on June 29, 2009.

In connection with establishing the Financing Agreement, on November 11, 2004 the Company issued warrants to purchase 500,000 shares of common stock at \$0.10 per share (See Note 5).

#### **Note 9 – COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENTS**

##### **Leases**

The Company leases showroom, office and warehouse space under operating leases expiring through 2011.

The future minimum lease payments, excluding escalation charges, are as follows (in thousands):

<u>Operating leases</u>	
2009	381
2010	396
2011	<u>166</u>
	<u>\$ 943</u>

In accordance with SFAS No. 13, "Accounting for Leases," non-cancellable operating leases with scheduled rent increases require that rent expense be recognized on a straight-line basis over the lease term. Rent expense for the year ended December 31, 2007 includes approximately \$10,000 which relates to the amortized portion of the scheduled rent increases, and to the first month rent abatement.

Total rent expense charged to operations for the years ended December 31, 2008 and 2007 was approximately \$392,000 and \$389,000 respectively.

### **Employment Agreements**

The Company has employment agreements with two executives which provide for total annual base compensation aggregating approximately \$730,000, as well as for health insurance and other fringe benefits, and contains certain confidentiality and non-compete provisions. The agreements expire in March and December 2010, respectively, and provide that in the event the Company terminates their employment without cause, the company will pay severance which, in the aggregate, could approximate \$1 million.

### **Separation Agreement**

On July 26, 2007, Andre Muller resigned as a director and officer of the Company. Prior to his resignation, Mr. Muller served as a director and its President and Chief Operating Officer. Under the terms of an agreement between the Company and Mr. Muller, the Company, for the period ended July 26, 2008 paid to Mr. Muller amounts equal to the salary installments (net of withholding taxes) he would have received during this period at the annual rate of \$400,000 that applied prior to his resignation. In addition, the Company paid 50% of the cost of COBRA coverage for the period ended July 26, 2008. For the year ended December 31, 2007, the Company accrued approximately \$430,000 in connection with the agreement, which is included in operating costs and expenses.