

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
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INDEPENDENT AUDITOR'S REPORT

To the Stockholders
Alliance Distributors Holding Inc.
and Subsidiary

We have audited the accompanying consolidated balance sheet of Alliance Distributors Holding Inc. and Subsidiary (collectively the "Company") as of June 30, 2010, and the related consolidated statements of income, stockholders' equity and cash flows for the six months then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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 audits 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Alliance Distributors Holding Inc. and Subsidiary as of June 30, 2010, and the results of their operations and their cash flows for the six months then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company changed its year-end from December 31 to June 30.

Mayer Hoffman McCann CPAs

New York, New York
August 16, 2010

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEET
JUNE 30, 2010
(In thousands, except per share amounts)

ASSETS

CURRENT ASSETS:

Cash and equivalents	\$ 906
Accounts receivable-net	3,909
Inventory	5,849
Due from vendors	257
Prepaid expenses and other current assets	236
Deferred income taxes	<u>277</u>

Total current assets 11,434

PROPERTY AND EQUIPMENT – NET 318

DEFERRED INCOME TAXES 185

OTHER ASSETS 98

TOTAL \$12,035

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Notes payable – bank	\$ 5,131
Accounts payable	2,289
Accrued expenses and other current liabilities	321
Income taxes payable	17
Current portion of long-term obligations	<u>15</u>

Total current liabilities 7,773

DEFERRED LEASE OBLIGATIONS 28

COMMITMENTS AND CONTINGENT LIABILITIES

STOCKHOLDERS' EQUITY:

Series A Convertible Non-Redeemable Preferred Stock, \$.001 par value; 8,269 shares authorized, none issued and outstanding at June 30, 2010	-
Common stock, \$.001 par value; 100,000 shares authorized; 52,883 shares issued and outstanding at June 30, 2010	53
Additional paid-in capital	3,746
Retained earnings	<u>435</u>

Total stockholders' equity 4,234

TOTAL \$12,035

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED INCOME STATEMENT
SIX MONTHS ENDED JUNE 30, 2010
(In thousands, except per share amounts)

NET SALES	\$30,514
COST OF SALES	<u>26,236</u>
GROSS PROFIT	4,278
OPERATING COSTS AND EXPENSES	<u>3,569</u>
INCOME FROM OPERATIONS	709
Interest expense	<u>228</u>
INCOME BEFORE PROVISION FOR INCOME TAXES	481
Provision for income taxes	<u>184</u>
NET INCOME	<u>\$ 297</u>
Net income per share – basic and diluted	<u>\$ 0.01</u>
Weighted-average common shares outstanding – basic	<u>52,883</u>
Weighted-average common shares outstanding – diluted	<u>52,883</u>

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
SIX MONTHS ENDED JUNE 30, 2010
(In thousands)

	Preferred Stock		Common Stock		Additional	Retained	Total
	Shares	Amount	Shares	Amount	Paid in Capital	Earnings	Stockholders' Equity
Balance, January 1, 2010	-	\$ -	52,883	\$ 53	\$ 3,727	\$ 138	\$ 3,918
Equity compensation expense	-	-	-	-	19	-	19
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>297</u>	<u>297</u>
Balance, June 30, 2010	<u>-</u>	<u>\$ -</u>	<u>52,883</u>	<u>\$ 53</u>	<u>\$ 3,746</u>	<u>\$ 435</u>	<u>\$ 4,234</u>

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CASH FLOWS
SIX MONTHS ENDED JUNE 30, 2010
(In thousands)

OPERATING ACTIVITIES:	
Net income	\$ 297
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	125
Provision for doubtful accounts	50
Equity compensation expense	19
Amortization of deferred financing costs	19
Deferred rent	(9)
Deferred income taxes	(21)
Changes in operating assets and liabilities:	
Accounts receivable	3,048
Inventory	305
Due from vendors	109
Prepaid expenses and other assets	7
Accounts payable	(3,075)
Accrued expenses and other current liabilities	<u>(403)</u>
Net cash provided by operating activities	<u>471</u>
INVESTING ACTIVITIES:	
Purchase of property and equipment	<u>(73)</u>
Net cash used in investing activities	<u>(73)</u>
FINANCING ACTIVITIES:	
Repayments of note payable-bank, net of proceeds	(446)
Payment of long-term obligations	(10)
Payment of deferred financing costs	<u>(38)</u>
Net cash used in financing activities	<u>(494)</u>
NET DECREASE IN CASH AND EQUIVALENTS	(96)
CASH AND EQUIVALENTS, BEGINNING OF PERIOD	<u>1,002</u>
CASH AND EQUIVALENTS, END OF PERIOD	<u>\$ 906</u>

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
Notes to Consolidated Financial Statements

Note 1 - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Alliance Distributors Holding Inc. ("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. In October 2009, Alliance formed a wholly-owned subsidiary, Alliance Metaversal Studio LLC, which acquired the video game assets of Metaversal Studios, Inc., a developer of downloadable and social content video games. The consolidated financial statements include the accounts of Alliance and its wholly-owned subsidiary (collectively, the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation. The Company operates as a single segment.

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.

Change in Financial Year-End

The Company changed its year-end from December 31 to June 30 to better align its financial reporting year-end with its business cycle.

Recent Accounting Pronouncements

ASC Topic 985-605, Software Revenue Recognition

In October 2009, new authoritative guidance regarding "Software — Certain Revenue Arrangements That Include Software Elements" was issued. This guidance amends the scope of pre-existing software revenue guidance by removing from the guidance non-software components of tangible products and certain software components of tangible products. This new standard is effective in fiscal years beginning on or after June 15, 2010; however, early adoption is permitted. The Company does not expect to have a material impact on its consolidated financial statements upon adoption.

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 June 30, 2010, the Company's allowance for doubtful accounts totaled approximately \$409,000.

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. Inventory as of June 30, 2010 includes approximately \$337,000 that was in transit from vendors. 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 consolidated 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 June 30, 2010.

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

Intangible Assets Subject to Amortization

Intangible assets subject to amortization resulted from the purchase of the video game assets of Metaversal Studios, Inc. (Note 5), consisting principally of software development costs for video games in development. Amortization of software development costs and licenses commences when a product is released and is recorded on a title-by-title basis in cost of goods sold.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization, are 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 carryforwards 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 establishes accruals for uncertain tax positions taken or expected to be taken in a tax return when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Favorable or unfavorable adjustment of the accrual for any particular issue would be recognized as an increase or decrease to income tax expense in the period of a change in facts and circumstances.

As of June 30, 2010, there are no unrecognized tax benefits, and there have been no income tax related interest or penalties accrued in the six months ended June 30, 2010. 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 December 31, 2006 are subject to tax examination.

Operating Costs and Expenses

The Company includes shipping and handling costs in operating costs and expenses. For the six months ended June 30, 2010, the Company incurred approximately \$627,000 of such costs.

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 June 30, 2010 due to their short-term maturities. Borrowings under the financing agreement approximate fair value due to their variable interest rate.

Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed by dividing income 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 per share by application of the treasury stock method.

Options to purchase approximately 5.4 million shares of common stock during the six months ended June 30, 2010 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.

Stock-Based Compensation

The Company recognizes compensation expense for all equity-based compensation awards issued to employees based on the grant date fair value of those awards.

Note 2 – SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

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

Cash paid during the six month period ended June 30, 2010 for:

Interest	<u>\$256</u>
Income taxes	<u>\$641</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 six month period ended June 30, 2010, one customer with multiple divisions accounted for approximately 37% of the Company's sales. No other customer accounted for more than 10% of the Company's sales in the six month 2010 period. At June 30, 2010, the amount due from this customer was approximately \$2.7 million, and is included in accounts receivable on the accompanying consolidated balance sheet.

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 six months ended June 30, 2010, the Company's four largest suppliers in the aggregate accounted for approximately 51% of total purchases (with one accounting for 17% alone) and the ten largest suppliers in the aggregate accounted for approximately 78% of total purchases. At June 30, 2010, the amount due to these four suppliers was approximately \$1.1 million, and is included in accounts payable on the accompanying consolidated balance sheet. 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 at June 30, 2010:

Leasehold improvements	\$ 403
Computers, office equipment and furniture	425
Warehouse equipment	125
Vehicles	102
Software	<u>193</u>
Total	1,248
Less accumulated depreciation and amortization	<u>930</u>
	<u>\$ 318</u>

Depreciation and amortization expense approximated \$106,000 for the six months ended June 30, 2010.

Note 5 - Acquisition

In October 2009, the Company entered the downloadable content marketplace by acquiring the video game assets of Metaversal Studios, Inc., a developer of downloadable and social content video games. The purchase price consisted of an initial cash payment of \$25,000, a \$30,000 obligation payable ratably in the amount of \$1,666 per month over eighteen months and an earn-out approximating twenty percent of game profits (as defined) from the purchase date through September 30, 2010. In addition, the Company loaned \$30,000 to the seller, payable November 2010, and committed to establish a five percent of game profits bonus pool for Metaversal employees in the second year.

The estimated fair value of the purchase price recorded by the Company totaled \$55,000. The Company did not accrue future contingent consideration payments because, based on management's estimates of game profits for the period through September 30, 2010, it does not expect to be obligated to make contingent consideration payments. The Company will re-evaluate its estimates on a quarterly basis and any subsequent adjustments based on revised estimates will be recognized in the consolidated statement of income during the period of adjustment.

The acquisition was accounted for using the purchase method in accordance with "Business Combinations", Topic 805 of Financial Accounting Standards Board Accounting Standards Codification. Accordingly, the assets acquired were recorded at their estimated fair value of \$11,000 for property and equipment and \$44,000 for amortizable intangible assets. Amortizable intangible assets are included in the caption 'Other Assets' in the Company's consolidated balance sheet as of June 30, 2010. The acquired intangible assets are being amortized over a period of twelve to twenty-four months. Amortization expense, which is included in cost of sales, totaled approximately \$18,000 for the six months ended June 30, 2010.

Note 6 - FINANCING AGREEMENT

The Company has a financing agreement (the "Agreement") with Rosenthal & Rosenthal, Inc. ("Rosenthal"), pursuant to which the maximum credit facility, as defined, is \$15,000,000 (\$17,500,000 from November 1 to January 31 of each year). Interest on outstanding borrowings is payable at the prime rate plus 0.75% (but in no event shall the prime interest rate used in the computation be less than 4.75%). 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 guarantees in respect of borrowings under the Agreement. The Agreement is subject to automatic renewal on May 31 of each year (the "Renewal Date"), unless earlier terminated by Rosenthal on thirty days' notice or by the Company on each anniversary of the Renewal Date.

At June 30, 2010, 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 \$19,000 for the six months ended June 30, 2010 and is included in interest expense on the accompanying consolidated statement of income.

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 Warrant will expire earlier if the closing price of the common stock during a period designated in the Warrant is not less than \$0.40 per share. The Warrant 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 Warrant, which was amortized over the initial three-year life of the financing agreement.

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 June 30, 2010.

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 7 - INCOME TAXES

The components of the provision for (benefit from) income taxes for the six months ended June 30, 2010 are as follow (in thousands):

Current:	
Federal	\$ 165
State and local	<u>40</u>
	<u>205</u>
Deferred:	
Federal	(17)
State and local	<u>(4)</u>
	<u>(21)</u>
Total	<u>\$ 184</u>

Significant components of the Company's net deferred tax assets at June 30, 2010 are as follows (in thousands):

Net operating loss carryforwards	\$ 2,119
Reserves and other items not currently deductible	260
Equity compensation not currently deductible	189
Other	<u>18</u>
	2,586
Less: valuation allowance	<u>(2,124)</u>
Net deferred tax assets	<u>\$ 462</u>
Net deferred tax asset – current	\$ 277
Net deferred tax asset – non-current	<u>185</u>
	<u>\$ 462</u>

At June 30, 2010, 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 at June 30, 2010 due to the uncertainty surrounding the realization of the NOL's which resulted from a 2004 stock exchange agreement. Pursuant to Internal Revenue Code 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. The valuation allowance did not change during the six months ended June 30, 2010.

Note 8 - RETIREMENT PLAN

The Company sponsors a 401(k) contributory plan (the "Plan") for the benefit 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 six months ended June 30, 2010.

Note 9 - 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, 2010	5,500	\$.295	
Granted	-		
Forfeited	<u>(125)</u>	\$.122	
Outstanding – June 30, 2010	5,375	\$.299	5.3 years
Exercisable at June 30, 2010	5,121	\$.304	5.1 years

All of the issued options are ten-year non-qualified stock option grants. In 2009, the Company granted options to purchase 100,000 common shares to each of three independent directors of the Company. In 2008, the Company granted options to purchase 100,000 common shares to each of three different independent directors of the Company. Thirty percent of the option grant vested immediately and the remaining seventy percent vests in eight equal quarterly installments. All other previous stock option grants vest ratably in twelve equal quarterly installments.

The fair value of the options-pricing model was calculated with the following weighted-average assumptions used: risk-free interest rate-3.6%; expected life six to seven 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. There were no stock options granted during the six months ended June 30, 2010.

For the six months ended June 30, 2010, share-based compensation expense related to the Company's 2004 Stock Plan totaled approximately \$19,000 and is included in operating costs and expenses. In addition, at June 30, 2010, total compensation cost related to non-vested stock options not yet recognized totaled approximately \$40,000. This cost is expected to be recognized over a weighted-average period of approximately fourteen months.

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, 2010	496	\$.138
Granted in 2010	-	
Unvested portion forfeited in 2010	(92)	\$.10
Vested in 2010	<u>(151)</u>	\$.145
Non-vested – June 30, 2010	<u>253</u>	\$.148

Warrants

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 6).

Note 10 – 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):

Operating leases

Fiscal year ending June 30, 2011

\$370

For non-cancelable operating leases with scheduled rent increases, the Company recognized rent expense on a straight-line basis over the lease term. Rent expense for the six months ended June 30, 2010 was reduced by approximately \$10,000 related to the amortized portion of the scheduled rent increases, and to the first month rent abatement.

Total rent expense charged to operations for the six months ended June 30, 2010 was approximately \$207,000.

Employment Agreement

The Company has an employment agreement with an executive which provides for annual base compensation, health insurance and other fringe benefits, and contains certain confidentiality and non-compete provisions. The agreement expires in March 2012 and provides that in the event the Company terminates their employment without cause, the Company will pay severance.

Subsequent events

These consolidated financial statements considered subsequent events through August 16, 2010, the date the financial statements were available to be issued.