

**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 sheets of Alliance Distributors Holding Inc. and Subsidiary (collectively the "Company") as of December 31, 2009 and 2008, and the related consolidated statements of income and stockholders' equity and cash flows for the years 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 audits.

We conducted our audits 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 audits provide 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 December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

MHM Mahoney Cohen CPAs

New York, New York
March 29, 2010

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2009 AND 2008
(In Thousands, except per share amounts)

	<u>2009</u>	<u>2008</u>
ASSETS		
CURRENT ASSETS:		
Cash and equivalents	\$ 1,002	\$ 924
Accounts receivable-net	7,007	5,334
Inventory	6,154	7,262
Due from vendors	366	342
Prepaid expenses and other current assets	221	215
Deferred income taxes	<u>260</u>	<u>263</u>
Total current assets	15,010	14,340
PROPERTY AND EQUIPMENT – NET	352	501
DEFERRED INCOME TAXES	181	178
OTHER ASSETS	<u>119</u>	<u>88</u>
TOTAL	<u>\$15,662</u>	<u>\$15,107</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Notes payable – bank	\$ 5,577	\$ 6,806
Accounts payable	5,364	4,630
Accrued expenses and other current liabilities	398	334
Income taxes payable	343	91
Current portion of long-term obligations	<u>20</u>	<u>-</u>
Total current liabilities	<u>11,702</u>	<u>11,861</u>
DEFERRED LEASE OBLIGATIONS	<u>37</u>	<u>50</u>
LONG-TERM OBLIGATIONS	<u>5</u>	<u>-</u>
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 December 31, 2009 and 2008, respectively	-	-
Common stock, \$.001 par value; 100,000 shares authorized; 52,883 shares issued and outstanding at December 31, 2009 and 2008, respectively	53	53
Additional paid-in capital	3,727	3,662
Retained earnings (accumulated deficit)	<u>138</u>	<u>(519)</u>
Total stockholders' equity	<u>3,918</u>	<u>3,196</u>
TOTAL	<u>\$15,662</u>	<u>\$15,107</u>

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED INCOME STATEMENTS
YEARS ENDED DECEMBER 31, 2009 and 2008
(In thousands, except per share amounts)

	<u>2009</u>	<u>2008</u>
NET SALES	\$69,077	\$92,311
COST OF GOODS SOLD	<u>60,034</u>	<u>83,582</u>
GROSS PROFIT	9,043	8,729
OPERATING COSTS AND EXPENSES	<u>7,513</u>	<u>7,197</u>
INCOME FROM OPERATIONS	1,530	1,532
Interest expense	<u>453</u>	<u>580</u>
INCOME BEFORE PROVISION FOR (BENEFIT FROM) INCOME TAXES	1,077	952
Provision for (benefit from) income taxes	<u>420</u>	<u>(84)</u>
NET INCOME	<u>\$ 657</u>	<u>\$ 1,036</u>
Net income per share – basic and diluted	<u>\$ 0.01</u>	<u>\$ 0.02</u>
Weighted average common shares outstanding – basic	<u>52,883</u>	<u>52,965</u>
Weighted average common shares outstanding – diluted	<u>52,883</u>	<u>53,449</u>

See notes to consolidated financial statements.

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2009 and 2008
(In thousands)**

	Preferred Stock		Common Stock		Additional	Retained	Total
	Shares	Amount	Shares	Amount	Paid in Capital	Earnings (Accumulated Deficit)	Stockholders' Equity
Balance, January 1, 2008	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	-	\$ -	52,883	\$ 53	\$ 3,662	\$ (519)	\$ 3,196
Equity compensation expense	-	-	-	-	65	-	65
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>657</u>	<u>657</u>
Balance, December 31, 2009	<u>-</u>	<u>\$ -</u>	<u>52,883</u>	<u>\$ 53</u>	<u>\$ 3,727</u>	<u>\$ 138</u>	<u>\$ 3,918</u>

See notes to consolidated financial statements.

ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2009 AND 2008
(In thousands)

	<u>2009</u>	<u>2008</u>
OPERATING ACTIVITIES:		
Net income	\$ 657	\$ 1,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	220	204
Provision for doubtful accounts	190	115
Equity compensation expense	65	98
Amortization of deferred financing costs	42	56
Deferred rent	(13)	-
Deferred income taxes	-	(223)
Changes in operating assets and liabilities:		
Accounts receivable	(1,863)	1,196
Inventory	1,108	3,060
Due from vendors	(24)	(270)
Prepaid expenses and other assets	33	(111)
Accounts payable	734	(4,307)
Accrued expenses and other current liabilities	<u>316</u>	<u>(120)</u>
Net cash provided by operating activities	<u>1,465</u>	<u>734</u>
INVESTING ACTIVITIES:		
Purchase of property and equipment	(60)	(99)
Acquisition of assets of Metaversal Studios, Inc.	(25)	-
Note receivable in connection with acquisition	<u>(30)</u>	<u>-</u>
Net cash used in investing activities	<u>(115)</u>	<u>(99)</u>
FINANCING ACTIVITIES:		
Proceeds from note payable, net of repayments – bank	-	19
Repayments of note payable, net of proceeds – bank	(1,229)	-
Payment of long-term obligations	(5)	(5)
Payment of deferred financing costs	<u>(38)</u>	<u>(45)</u>
Net cash used in financing activities	<u>(1,272)</u>	<u>(31)</u>
INCREASE IN CASH AND EQUIVALENTS	78	604
CASH AND EQUIVALENTS, BEGINNING OF YEAR	<u>924</u>	<u>320</u>
CASH AND EQUIVALENTS, END OF YEAR	<u>\$ 1,002</u>	<u>\$ 924</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.

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 reclassifications have been made to the 2008 financial statements to conform to the 2009 presentation.

Recent Accounting Pronouncements

FASB Codification

In June 2009, the Financial Accounting Standards Board ("FASB") issued ASU No. 2009-1, Generally Accepted Accounting Principles ("ASC Topic 105"), which establishes the FASB Accounting Standards Codification ("Codification" or "ASC") as the official single source of authoritative U.S. generally accepted accounting principles ("U.S. GAAP"), superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF") and related literature. The Codification also includes all relevant Securities and Exchange Commission ("SEC") guidance organized using the same topical structure in separate sections within the Codification. After the Codification became effective (interim and annual periods ending on or after September 15, 2009), only one level of authoritative U.S. GAAP exists. All other literature will be considered non-authoritative. The Codification does not change existing U.S. GAAP. The principal impact on the Company's financial statements is limited to disclosures as all future references to authoritative accounting literature will be referenced in accordance with the Codification. Pursuant to the provisions of ASC Topic 105, the Company has updated references to GAAP in its financial statements. The adoption of ASC Topic 105 did not impact the Company's financial position or results of operations.

ASC Topic 805, Business Combinations

The Company adopted FASB Statement No. 141(R), Business Combination, which was codified into ASC Topic 805, ("Topic 805"), effective January 1, 2009. Topic 805 requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose the information necessary to evaluate and understand the nature and financial effect of the business combination. In addition, Topic 805 requires that contingent purchase consideration be recognized at fair value on the acquisition date with subsequent adjustments recognized in the consolidated statement of operations. The impact of Topic 805 on the Company's consolidated financial statements will depend upon the nature, terms and size of the acquisitions it completes (see Note 5).

ASC Topic 855, Subsequent Events

In February 2009, the FASB issued Statement No. 165, Subsequent Events, which was primarily codified into ASC Topic 855, Subsequent Events ("Topic 855"), which establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are available to be issued. More specifically, Topic 855 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that should be made about events or transactions that occur after the balance sheet date. Topic 855 provides largely the same guidance on subsequent events which previously existed only in auditing literature. Adoption of the statement did not have an impact on the Company's consolidated financial statements. These consolidated financial statements considered subsequent events through March 29, 2010, the date the financial statements were available to be issued.

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 December 31, 2009 and 2008, the Company's allowance for doubtful accounts totaled approximately \$359,000 and \$205,000, 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 consolidated balance sheets. 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, 2009 and 2008.

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. As of December 31, 2009, the Company had not released any video games and as such, has not commenced amortization of its intangible assets.

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 December 31, 2009 and 2008, there are no unrecognized tax benefits, and there have been no income tax related interest or penalties accrued in the years ended December 31, 2009 and 2008. 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 years ended December 31, 2009 and 2008, the Company incurred approximately \$1,293,000 and \$1,228,000 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, 2009 and 2008 due to their short-term maturities. Borrowings under the financing agreement approximate fair value due to their variable interest rate.

Net Income (Loss) 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. 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.

Options to purchase 5.5 million and 4.3 million shares of common stock in the years ended December 31, 2009 and 2008, 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.

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 year for:	<u>2009</u>	<u>2008</u>
Interest	<u>\$465</u>	<u>\$603</u>
Income taxes	<u>\$167</u>	<u>\$ 17</u>

Supplemental disclosure of non-cash investing and financing activities (in thousands):

During 2009, the acquisition of Metaveral Studios, Inc. was partially financed by an obligation payable of \$30.

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 year ended December 31, 2009, one customer accounted for approximately 19% of the Company's sales. For the year ended December 31, 2008, a different customer accounted for approximately 12% of the Company's sales. No other customer accounted for more than 10% of the Company's sales in 2009 and 2008.

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, 2009, the Company's three largest suppliers in the aggregate accounted for approximately 47% of total purchases (with one accounting for 23% alone) and the ten largest suppliers in the aggregate accounted for approximately 77% of total purchases. 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. At December 31, 2009 and 2008, the amount due to these three suppliers was approximately \$1.9 million and \$2.1 million, respectively, and is included in accounts payable on the accompanying consolidated 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:

	December 31,	
	<u>2009</u>	<u>2008</u>
Leasehold improvements	\$ 403	\$ 403
Computers, office equipment and furniture	385	367
Warehouse equipment	125	125
Vehicles	78	78
Software	<u>184</u>	<u>190</u>
Total	1,175	1,163
Less accumulated depreciation and amortization	<u>823</u>	<u>662</u>
	<u>\$ 352</u>	<u>\$ 501</u>

Depreciation and amortization expense approximated \$220,000 and \$204,000 for the years ended December 31, 2009 and 2008, respectively.

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) for the period 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 statements of income during the period of adjustment.

The acquisition was accounted for using the purchase method in accordance with "Business Combinations", Topic 805 of FASB ASC. 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 December 31, 2009. There was no amortization expense in 2009.

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 commencing 2010 the ("Renewal Date"), unless earlier terminated by Rosenthal on thirty days' notice or by the Company on each anniversary of the Renewal Date.

At December 31, 2009, 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 \$42,000 and \$56,000 for the years ended December 31, 2009 and 2008, 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 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 December 31, 2009.

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 (benefit from) provision for income taxes are as follow (in thousands):

	<u>2009</u>	<u>2008</u>
Current:		
Federal	\$ 338	\$ 100
State and local	<u>82</u>	<u>39</u>
	<u>420</u>	<u>139</u>
Deferred:		
Federal	-	(182)
State and local	<u>-</u>	<u>(41)</u>
	<u>-</u>	<u>(223)</u>
Total	<u>\$ 420</u>	<u>\$ (84)</u>

For the year ended December 31, 2008, 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, 2009 and 2008 are as follows (in thousands):

	<u>2009</u>	<u>2008</u>
Net operating loss carryforwards	\$ 2,121	\$ 2,124
Reserves and other items not currently deductible	224	238
Equity compensation not currently deductible	179	150
Expenses not currently deductible	32	20
Costs capitalized to inventory for tax purposes	19	25
Other	<u>(10)</u>	<u>8</u>
	2,565	2,565
Less: valuation allowance	<u>(2,124)</u>	<u>(2,124)</u>
Net deferred tax assets	<u>\$ 441</u>	<u>\$ 441</u>
Net deferred tax asset – current	\$ 260	\$ 263
Net deferred tax asset – non-current	<u>181</u>	<u>178</u>
	<u>\$ 441</u>	<u>\$ 441</u>

At December 31, 2009, 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 December 31, 2009 and 2008 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. Based upon 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 reversal of the valuation allowance resulted in a tax benefit of approximately \$547,000 in the year ended December 31, 2008.

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 years ended December 31, 2009 and 2008.

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, 2009	5,075	\$.307	
Granted	425	\$.150	
Forfeited	<u>-</u>		
Outstanding – December 31, 2009	5,500	\$.295	5.8 years
Exercisable at December 31, 2009	5,004	\$.306	5.5 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. In addition, the Company granted options to purchase a total of 125,000 and 420,000 common shares to various employees in 2009 and 2008, respectively. These stock options, as well as all other 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, 2009 and 2008, share-based compensation expense related to the Company's 2004 Stock Plan totaled approximately \$65,000 and \$98,000, respectively, and is included in operating costs and expenses. In addition, at December 31, 2009, total compensation cost related to non-vested stock options not yet recognized totaled

approximately \$69,000. This cost is expected to be recognized over a weighted average period of approximately nineteen months.

The fair value of the options-pricing model was calculated with the following weighted-average assumptions used for grants during the years ended December 31, 2009 and 2008: 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.

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, 2009	541	\$.16
Granted in 2009	425	\$.114
Unvested portion forfeited in 2009	-	
Vested in 2009	<u>(470)</u>	\$.142
Non-vested – December 31, 2009	<u>496</u>	\$.138

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

2010	\$412
2011	<u>166</u>
	<u>\$578</u>

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 year ended December 31, 2009 was reduced by approximately \$13,000 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 years ended December 31, 2009 and 2008 was approximately \$406,000 and \$392,000, 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. In January 2010, one of the employment agreements was terminated and in February 2010, the second employment agreement was extended to expire in March 2012.