

ALLIANCE DISTRIBUTORS HOLDING INC.  
AND SUBSIDIARY

Consolidated Financial Statements

June 30, 2011

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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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, 2011, and the related consolidated statements of income, stockholders' equity and cash flows for the year 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 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 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, 2011 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*Mayer Hoffman McCann CPAs*

New York, New York  
August 18, 2011

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEET**  
**JUNE 30, 2011**  
(In thousands, except per share amounts)

**ASSETS**

**CURRENT ASSETS:**

Cash and equivalents	\$ 988
Accounts receivable-net	3,457
Inventory	6,581
Advances to suppliers	153
Prepaid expenses and other current assets	145
Deferred income taxes	<u>268</u>

**Total current assets** 11,592

**PROPERTY AND EQUIPMENT – NET** 153

**DEFERRED INCOME TAXES** 230

**OTHER ASSETS** 81

**TOTAL** \$12,056

**LIABILITIES AND STOCKHOLDERS' EQUITY**

**CURRENT LIABILITIES:**

Notes payable – bank	\$ 5,589
Accounts payable	2,012
Accrued expenses and other current liabilities	<u>240</u>

**Total current liabilities** 7,841

**COMMITMENTS AND CONTINGENCIES**

**STOCKHOLDERS' EQUITY:**

Series A Convertible Non-Redeemable Preferred Stock, \$.001 par value; 8,269 shares authorized, none issued and outstanding	-
Common stock, \$.001 par value; 100,000 shares authorized; 44,157 shares issued and outstanding	44
Additional paid-in capital	3,451
Retained earnings	<u>720</u>

**Total stockholders' equity** 4,215

**TOTAL** \$12,056

See notes to consolidated financial statements.

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY**  
**CONSOLIDATED INCOME STATEMENT**  
**YEAR ENDED JUNE 30, 2011**  
(In thousands, except per share amounts)

<b>NET SALES</b>	\$57,004
<b>COST OF SALES</b>	<u>49,464</u>
<b>GROSS PROFIT</b>	7,540
<b>OPERATING COSTS AND EXPENSES</b>	<u>6,544</u>
<b>INCOME FROM OPERATIONS</b>	996
Interest expense	<u>532</u>
<b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>	464
Provision for income taxes	<u>179</u>
<b>NET INCOME</b>	<u>\$ 285</u>
<b>Net income per share – basic and diluted</b>	<u>\$ 0.01</u>
<b>Weighted-average common shares outstanding – basic</b>	<u>51,353</u>
<b>Weighted-average common shares outstanding – diluted</b>	<u>51,353</u>

See notes to consolidated financial statements.

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
**YEAR ENDED JUNE 30, 2011**  
(In thousands)

	Preferred Stock		Common Stock		Additional	Retained	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Earnings	Stockholders' Equity
Balance, July 1, 2010	-	\$ -	52,883	\$ 53	\$ 3,746	\$ 435	\$ 4,234
Purchase and retirement of common stock	-	-	(8,726)	(9)	(326)	-	(335)
Equity compensation expense	-	-	-	-	31	-	31
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>285</u>	<u>285</u>
Balance, June 30, 2011	<u>-</u>	<u>\$ -</u>	<u>44,157</u>	<u>\$ 44</u>	<u>\$ 3,451</u>	<u>\$ 720</u>	<u>\$ 4,215</u>

See notes to consolidated financial statements.

**ALLIANCE DISTRIBUTORS HOLDING INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
**YEAR ENDED JUNE 30, 2011**  
(In thousands)

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<b>OPERATING ACTIVITIES:</b>	
Net income	\$ 285
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	223
Provision for doubtful accounts	15
Equity compensation expense	31
Amortization of deferred financing costs	38
Deferred rent	(28)
Deferred income taxes	(36)
Changes in operating assets and liabilities:	
Accounts receivable	437
Inventory	(732)
Advances to suppliers	104
Prepaid expenses and other assets	86
Accounts payable	(269)
Accrued expenses and other current liabilities	<u>(98)</u>
Net cash provided by operating activities	<u>56</u>
<b>INVESTING ACTIVITIES:</b>	
Purchase of property and equipment	<u>(44)</u>
Net cash used in investing activities	<u>(44)</u>
<b>FINANCING ACTIVITIES:</b>	
Proceeds from note payable-bank, net of repayments	458
Payment of long-term obligations	(15)
Purchase and retirement of common stock	(335)
Payment of deferred financing costs	<u>(38)</u>
Net cash provided by financing activities	<u>70</u>
<b>NET INCREASE IN CASH AND EQUIVALENTS</b>	<b>82</b>
<b>CASH AND EQUIVALENTS, BEGINNING OF YEAR</b>	<b><u>906</u></b>
<b>CASH AND EQUIVALENTS, END OF YEAR</b>	<b><u>\$ 988</u></b>

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.

**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.

**Recent Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-05, Comprehensive Income (Accounting Standards Codification ("ASC") Topic 220) - Presentation of Comprehensive Income. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity and requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments are effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The guidance requires changes in presentation only and will have no significant impact on the Company's consolidated financial statements.

**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, 2011, the Company's allowance for doubtful accounts totaled approximately \$297,000.

**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. 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, 2011.

### **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 sales.

### **Software Development Costs**

Pursuant to ASC 985-605, software development costs incurred for video games to be sold or otherwise marketed are required to be capitalized after the technological feasibility of the software is established. Under the Company's current practice of developing downloadable and social content video games, the technological feasibility of the underlying software for a new game is not established until substantially all product development and testing is complete and the game is ready for release. As such, costs incurred in downloadable game development are included in operating costs and expenses until such time as the product is ready for release. Thereafter, costs incurred for ongoing maintenance and upgrades are included in cost of sales.

### **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.

In accordance with the criteria set forth in ASC 985-605, *Software: Revenue Recognition* and Staff Accounting Bulletin (“SAB”) No. 104, *Revenue Recognition*, the Company generally recognizes a sale of downloadable digital content when the download is purchased by a customer.

### **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, 2011, there are no unrecognized tax benefits, and there have been no income tax related interest or penalties accrued in the year ended June 30, 2011. 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, 2007 are subject to tax examination.

### **Operating Costs and Expenses**

The Company includes shipping and handling costs in operating costs and expenses. For the year ended June 30, 2011, the Company incurred approximately \$975,000 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, 2011 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 5.1 million shares of common stock during the year ended June 30, 2011 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 ended June 30, 2011 for:

Interest	<u>\$524</u>
Income taxes	<u>\$173</u>

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

### 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 June 30, 2011, one customer with multiple divisions accounted for approximately 34% of the Company's sales, and a second customer accounted for 15% of the Company's sales. No other customer accounted for more than 10% of the Company's sales in the fiscal 2011 period. At June 30, 2011, the amount due from one customer approximated \$2.5 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 year ended June 30, 2011, the Company's two largest suppliers in the aggregate accounted for approximately 30% of total purchases and the ten largest suppliers in the aggregate accounted for approximately 73% of total purchases. 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, 2011:

Leasehold improvements	\$ 403
Computers, office equipment and furniture	358
Software	199
Vehicles	102
Warehouse equipment	<u>98</u>
Total	1,160
Less accumulated depreciation and amortization	<u>1,007</u>
	<u>\$ 153</u>

Depreciation and amortization expense approximated \$201,000 for the year ended June 30, 2011.

#### **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 estimated fair value of the purchase price recorded by the Company totaled \$55,000. 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 June 30, 2011. 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 \$22,000 for the year ended June 30, 2011.

#### **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 signed a limited guarantee 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, 2011, 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 \$38,000 for the year ended June 30, 2011 and is included in interest expense on the accompanying consolidated income statement.

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 these covenants at June 30, 2011.

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 year ended June 30, 2011 are as follows (in thousands):

Current:	
Federal	\$ 170
State and local	<u>45</u>
	<u>215</u>
Deferred:	
Federal	(29)
State and local	<u>(7)</u>
	<u>(36)</u>
Total	<u>\$ 179</u>

Significant components of the Company's net deferred tax assets at June 30, 2011 are as follows (in thousands):

Net operating loss carryforwards	\$ 2,116
Reserves and other items not currently deductible	243
Equity compensation not currently deductible	162
Other	<u>101</u>
	2,622
Less: valuation allowance	<u>(2,124)</u>
Net deferred tax assets	<u>\$ 498</u>
Net deferred tax asset – current	\$ 268
Net deferred tax asset – non-current	<u>230</u>
	<u>\$ 498</u>

At June 30, 2011, the Company had federal and state net operating loss carryforwards (NOL's) of approximately \$5.4 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, 2011 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 year ended June 30, 2011.

## 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 year ended June 30, 2011.

## 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 – July 1, 2010	5,375	\$.299	
Granted	-		
Forfeited	<u>(300)</u>	\$.188	
Outstanding – June 30, 2011	<u>5,075</u>	\$.306	4.1 years
Exercisable at June 30, 2011	5,040	\$.306	4.1 years

All of the issued options are ten-year non-qualified stock option grants. In 2008 and 2009, the Company granted options to purchase a total of 600,000 common shares to its then independent directors, for which thirty percent of the option grant vested immediately and the remaining seventy percent vested 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 year ended June 30, 2011.

For the year ended June 30, 2011, share-based compensation expense related to the Company's 2004 Stock Plan totaled approximately \$31,000 and is included in operating costs and expenses. In addition, at June 30, 2011, compensation cost related to non-vested stock options not yet recognized totaled approximately \$6,000. This cost is expected to be recognized over a weighted-average period of approximately three months.

The number and weighted-average grant-date fair value of non-vested stock options for the year ended June 30, 2011 is as follows:

	Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Non-vested – July 1, 2010	253	\$.148
Granted	-	
Unvested portion forfeited	-	
Vested	<u>(218)</u>	\$.146
Non-vested – June 30, 2011	<u>35</u>	\$.160

## **Note 10 – COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENTS**

### **Leases**

The Company leases its principal showroom, office and warehouse space under an operating lease which expires in May 2013. The Company rents certain other office and warehouse facilities under arrangements not exceeding one year.

The future minimum lease payments, excluding escalation charges, for leases having a remaining noncancelable term in excess of one year are as follows (in thousands):

#### **Operating leases**

Fiscal year ending June 30, 2012	\$270
Fiscal year ending June 30, 2013	<u>247</u>
Total	<u>\$517</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 June 30, 2011 was reduced by approximately \$28,000 related to the amortized portion of the scheduled rent increases, and to the first month's rent abatement.

Total rent expense charged to operations for the year ended June 30, 2011 was approximately \$424,000.

### **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.

### **Legal Proceedings**

The Company is subject to claims and litigation arising in the ordinary course of business. Management does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

### **Subsequent events**

These consolidated financial statements considered subsequent events through August 18, 2011, the date the financial statements were available to be issued.