

# ANNUAL REPORT

For the fiscal year ended December 31, 2007

of

## ELEGANT ILLUSIONS, INC.

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Revenues for the fiscal year ended December 31, 2007 were \$5,552,754.

The aggregate market value of the voting stock held by non-affiliates of the Company (those persons who, during the preceding three months, were not officers, directors or owners of 5% or more of the Company's outstanding stock) as of March 20, 2008, based on the last price of \$0.35 as of March 20, 2008 is \$587,196 based upon 1,677,703 Shares of Registrant's Common Stock held by non-affiliates. There is no material trading activity for the Company's Common Stock. Accordingly, the foregoing information should not be taken as an accurate indicator of the aggregate market value of the Company's voting stock held by non-affiliates.

The number of shares outstanding of the Company's classes of common equity (which excludes 153,612 treasury shares), as of March 20, 2008 is 5,992,834 shares, all of one class of \$.001 par value Common Stock.

In October 2002, Elegant Illusions, Inc. filed a Form 15 with the Securities and Exchange Commission terminating registration of its Common Stock under the Securities Exchange Act of 1934. As a result, it is no longer obligated to file periodic reports with the Securities and Exchange Commission. **This report is not an annual report on Form 10-K and does not include all disclosures required by such reports.**

ELEGANT ILLUSIONS, INC.  
Annual Report  
Year Ended December 31, 2007

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## **Description of Business**

### **General**

Elegant Illusions, Inc. (the "Company"), through its wholly-owned subsidiary, Elegant Illusions, Inc, a California corporation (the "Subsidiary"), is primarily in the retail created gem jewelry business and currently owns and operates 15 retail created gem jewelry stores, one fine jewelry store and one fine art gallery.

### **Created Gem Jewelry**

The retail created gem jewelry stores are located in:

#### **California**

Balboa  
Monterey (two stores),  
Palm Springs,  
Sacramento,  
San Diego and  
San Francisco

#### **Colorado**

Vail

#### **Florida**

Sarasota

#### **Hawaii**

Lahina  
Wailea

#### **Louisiana**

New Orleans (two  
stores)\* -

#### **Missouri**

Branson

#### **Nevada**

Laughlin

\* Includes the Riverwalk location that had been closed since Hurricane Katrina, but reopened in October 2007 (see “Effects of Hurricane Katrina” in “Management's Discussion and Analysis of Financial Condition and Results of Operations” below).

The created gem jewelry locations at Branson, New Orleans, Palm Springs, Sarasota, Vail and Wailea also sell fine jewelry. The Vail and Sarasota locations also sell fine art.

### **Fine Jewelry**

The fine jewelry store is located in Monterey, California.

### **Fine Art**

The fine art gallery is located on Bourbon Street in New Orleans, Louisiana, and operates under the name Cardinal Gallery; however, as discussed below, we plan on closing this location. The Vail and Sarasota locations previously operated under the Cardinal Gallery name and primarily sold fine art. These locations now operate under the Elegant Illusions name and, as noted above, sell fine jewelry, created gem jewelry and fine art. Fine art represents less than 3% of the Company's revenues.

Management on a continual basis for the last four years has invested strongly in inventory while gold was at lower prices. We have kept our leases in option form thereby being able to move with the changes in the economy. We have moved our jewelry design and price point to appeal to the upper middle class and above. The Company has recognized the trend of shrinking discretionary funds for the last several years. Management believes that this trend will continue and increase due to rising energy costs, the shrinking access to credit and lower wages because of the shrinking manufacturing base in America. In response to this trend, we have closed our non performing locations in an orderly manner and expect to close two or three additional stores (Elegant Illusions on Bourbon St., Cardinal Gallery on Bourbon St., and the Wailea location) in an orderly manner while maintaining a level of sales that will allow us to continue moving into different markets that have a maximum return with a minimal initial risk of capital investment. We are closing the two Bourbon Street locations in New Orleans because we were unable to renew our lease. We continue to evolve and move our concept into the upper classes where we believe we provide significant value and uniqueness. We believe a viable avenue to broaden sales of our Platinique products is through small and large retail companies. While we have yet to realize any substantive results in this area, we are continuing our efforts in this area by planning to attend national jewelry tradeshows in the USA, Canada and Europe. We anticipate lower sales, and store closures, however there will be corresponding lower expenses and we anticipate that we will be debt free.

In the coming year, we plan on testing, at two of our Elegant Illusions locations, a revised concept that will include fine jewelry and semi and precious stones. This new concept may also involve a name change at these two locations. The first will be the Elegant Illusions location on Cannery Row and Management expects this change to be complete by May 30, 2008. The second location to make this change will be the Doubletree store in Monterey and Management expects this change to be complete by the June 30, 2008.

In January 2007, the Company closed two created gem jewelry stores (Miromar and Philadelphia). In January 2008, the Company closed its San Francisco location because the landlord is redeveloping Ghirdelli Square and changing the concept from a Retail Mall to a Hotel Spa, Condominium project.

For more information on the performance of the Company's existing locations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" below.

The Company sells the original works of Norberto Martini, Bruno Paoli and Andrea Stella. Original works of these artists are featured at the Company's New Orleans Gallery and its Vail, Sarasota, Palm Springs, Branson, Wailea and/or one of its Monterey stores.

### Types of Stores

The created gem jewelry stores sell jewelry including rings, pendants, earrings, necklaces, bracelets, pearl enhancers and ear charms manufactured in 14 carat gold, sterling silver vermeil, platinique, stainless steel, gold bonded brass or gold bonded white metal. By using synthetic and laboratory grown stones, the Company offers created gem jewelry at substantially less than the cost of fine jewelry with natural gems of equal quality. In September 2006, the Company introduced its trademarked Platinique line and a new line of men's jewelry. Platinique is a registered trademark of Elegant Illusions Inc. The Company also sells fashion watches.

The fine jewelry store, *Steinbeck Jewelers* (Monterey), sells fine jewelry including rings, pendants, earrings, necklaces, bracelets, manufactured in 10 carat, 12 carat and 14 carat gold and other precious metals set with precious and semi-precious stones, certain gift ware items and original works of art by Andrea Stella and Bruno Paoli.

The *Cardinal Gallery* in New Orleans sells predominantly original oil paintings by the aforementioned contemporary Italian artists.

The Elegant Illusions stores in Branson, Palm Springs, Sarasota, Wailea and Vail sell original oil paintings by the aforementioned contemporary Italian artists, fine jewelry and created gem jewelry.

### Purchase of Inventory

The Company purchases its created gem jewelry merchandise directly from a number of manufacturers. Products purchased include stock items and jewelry designed by the Company. The jewelry sold in the fine jewelry store is primarily purchased directly from manufacturers and, to a lesser extent, from distributors. In certain cases, the Company will have jewelry fabricated from components sourced from several vendors. The Company purchases its fine Art directly from the artists. None of the Company's revenues are generated from sales of Art on consignment.

### Marketing

The Company's primary source of business results from "walk by" traffic and word of mouth. The Company also advertises in magazines and newspapers and on radio. Management believes that its choice of strategic location is its primary marketing tool. The Company's stores are located in high trafficked locations including malls and tourist areas. The strategic locations of the stores also helps mitigate seasonal factors; the tourist locations do higher volume during the summer and vacation times

while the mall and heavy shopping locations do higher volume around the traditional holiday times (e.g., Christmas, Valentines Day and Mothers Day).

### Competition

At this time, management believes that the Company has little direct competition. The Company knows of two created gem jewelry retail store chains that could compete with the Company if they were located within close proximity of the Company's stores - Impostors and Landau. Management believes that the Company would be able to compete even if stores were opened within close proximity of the Company's stores. The Company's created gem jewelry stores also compete indirectly with fine jewelry and costume jewelry retail stores; however, due to the type of merchandise sold and the difference in product price ranges, such competition has minimal if any affect on the Company's business.

### Employees

At March 24, 2008, the Company had approximately 52 employees. Current employees include the Company's three officers, one national sales manager, 9 store managers, 6 assistant managers, 28 sales personnel, one office manager and four clerical personnel.

### **Description of Properties**

The Company's executive offices are located at 542 Lighthouse Ave., Suite 5, Pacific Grove, California 93950. The facility consists of approximately 10,100 square feet utilized approximately as follows:

<u>Usage</u>	<u>Square Footage</u>
Executive office space	700
Administrative space	1,100
New facility assembly	1,700
Manager training	800
Warehouse space	5,000
Computer and file space	<u>900</u>
	<u>10,100</u>

The facility, excluding the warehouse space which is located on another floor in the building, is leased from an unaffiliated party pursuant to a one year lease that expires on February 28, 2009.

The Company has leased the warehouse portion of the premises for a period of six months, beginning March 1, 2008.

Management believes that the current executive facilities are sufficient for the Company's needs through the term of its lease.

As noted below, our Vail store is located in a retail condominium owned by the Company and the Sarasota location is leased from James Cardinal, Gavin Gear and Tamara Gear, the Company's executive officers, directors and principal stockholders. The other Company's stores are leased from unaffiliated

parties on various terms. Certain of the leases provide the landlord with a percentage of revenues generated at and from the specific leased location (see Note 4 to the Company's Consolidated Financial Statements).

On January 31, 2000, the Company purchased a retail site in Vail Colorado located at 160 Gore Creek Drive, The Lodge Apartment Condominium, Vail, Colorado 81657, where it opened and operates a store. The site is approximately 504 square feet.

In June 2001, the Company entered into a triple net lease for its store in Sarasota, Florida. The store is located at John Ringling Blvd, Sarasota, Florida. The store is owned by James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company. The specific lease terms require 60 monthly base payments of \$7,200. This lease was renewed through July 31, 2008, with 12 monthly base payments of \$5,330.85. Management believes that the lease terms for this store are comparable to those the Company would have obtained from an unaffiliated landlord.

On June 12, 2003, the Company entered into a triple net lease for a condominium in New Orleans to house out-of-town managers and staff. Management determined that leasing an apartment was less costly than renting hotel rooms. The condominium is owned by James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company. The specific lease terms require 12 monthly base payments of \$2,100 with the lease, as extended, expiring on July 31, 2008. Management believes that the lease terms for this condominium are comparable to those the Company would have obtained from an unaffiliated landlord.

On August 31, 2004, the Company entered into a triple net lease for a condominium in Vail to house its manager. Management determined that leasing an apartment was an incentive to hiring a manager. The condominium is owned by James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company. The current specific lease terms require 12 monthly base payments of \$1,380 with the lease, as extended, expiring on July 31, 2008. Management believes that the lease terms for this condominium are comparable to those the Company would have obtained from an unaffiliated landlord.

## Legal Proceedings

The Company is not presently a party to any material litigation not in the regular course of its business nor, to the Company's knowledge, is such litigation threatened.

## Submission of Matters to a Vote of Security Holders

None during 2007.

## Market for Registrant's Common Equity and Related Stockholder Matters

**Market Information** -- The principal U.S. market in which the Company's Common Stock (\$.001 par value, all of which are one class) is traded is in the over-the-counter market (Symbol: "EILL.PK").

The following tables set forth the range of high and low closing bid prices for the Company's Common Stock on a quarterly basis for the past two fiscal years. This information was obtained from the Pink Sheets, LLC. The bid prices reflect inter-dealer prices, without retail mark-up, mark-down, or commission and may not necessarily represent actual transactions.

The Company's Common Stock was delisted from NASDAQ on August 23, 2001, at which point it began to be quoted on the OTC Bulletin Board. In October 2002, the Company filed a Form 15 with the Securities and Exchange Commission terminating registration of its Common Stock under the Securities Exchange Act of 1934. As a result, on October 31, 2003, the Company's Common Stock was delisted from quotation on the OTC Bulletin Board and currently is quoted on the Pink Sheets.

TRADING IS EXTREMELY LIMITED AND OFTEN NON-EXISTENT FOR LENGTHY PERIODS. ACCORDINGLY, THE FOLLOWING PRICES SHOULD NOT BE TAKEN AS AN ACCURATE INDICATION OF THE MARKET VALUE OF THE COMPANY'S COMMON STOCK.

	<u>Bid Prices</u>	
	<u>High</u>	<u>Low</u>
<u>Period - Fiscal Year 2006</u>		
First Quarter ending March 31, 2006	0.32	0.31
Second Quarter ending June 30, 2006	0.31	0.31
Third Quarter ending September 30, 2006	0.31	0.31
Fourth Quarter ended December 31, 2006	0.31	0.31
<u>Period - Fiscal Year 2007</u>		
First Quarter ending March 31, 2007	0.32	0.31
Second Quarter ending June 30, 2007	0.32	0.32
Third Quarter ending September 30, 2007	0.32	0.31
Fourth Quarter ending December 31, 2007	0.32	0.31

**Holders** -- There were approximately 78 holders of record of the Company's Common Stock as of March 25, 2007 inclusive of those brokerage firms and/or clearing houses holding the Company's securities for their clientele (with each such brokerage house and/or clearing house being considered as one holder).

**Dividends** -- The Company has not paid or declared any dividends upon its Common Stock since its inception and does not contemplate or anticipate paying any dividends upon its Common Stock in the foreseeable future.

**Securities authorized for issuance under equity compensation plans** – As of December 31, 2007, there were no securities authorized for issuance under equity compensation plans.

### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Cautionary Statement on Forward-Looking Statements**

Except for the historical information contained herein, certain of the matters discussed in this report are "forward-looking statements," which involve certain risks and uncertainties, which could cause actual results to differ materially from those discussed herein. Forward-looking information generally is information stated to be anticipated, expected or projected by us. The following list, which is not intended to be an all encompassing list of risks and uncertainties affecting us and our business, summarizes several factors that could cause, or are causing, our actual results to differ from those anticipated or expected in these forward-looking statements: that low or negative growth in the economy or in the financial markets will reduce discretionary spending on goods such as those sold in our stores; that warehousing and distribution productivity and capacity can be further improved to support our distribution requirements; that changes in expenses (such as changes in our labor, rent and/or inventory purchase costs, including but not limited to significant changes in the cost of precious metals such as silver and gold) could adversely affect our results of operations; that competition may impact our sales efforts by diminishing sales and/or requiring us to cut prices; that seasonality of the retail created gem jewelry business or downturns in consumer spending during any quarter may adversely affect our operating results; that we may not be able to continue to manage our inventory and product supply effectively to respond to consumer demand; that fluctuations in created gem prices may negatively affect the business; that sustained adverse weather conditions may adversely affect our sales; that legal or governmental proceedings may have an adverse effect on our financial results or reputation; that alternate sources of merchandise supply may not be available on favorable terms to us; that key personnel who have been hired or retained by us may depart; or that changes in government or regulatory requirements may increase the cost of or adversely affect our operations.

We caution readers that any such forward-looking statements are based on our current expectations and beliefs but are not guarantees of future performance. Actual results could differ materially from those expressed or implied in the forward-looking statements.

## Results of Operations

### Fiscal Year ended December 31, 2007 Compared to Fiscal Year Ended December 31, 2006

Sales for the year ended December 31, 2007 decreased \$548,536 or approximately 9.0% when compared to the year ended December 31, 2006.

Our operations were and continue to be significantly and adversely affected by Hurricane Katrina. In addition to all three New Orleans locations being closed on and after August 29, 2005, the Riverwalk location sustained substantial damage. Our other two New Orleans locations reopened December 2, 2005 and our Riverwalk store re-opened, in another location within the Riverwalk Mall, October 12, 2007) (see “Effects of Hurricane Katrina” below).

Management believes that these significant decreases in Company wide sales were a direct result of closing locations and a decrease in same store revenues in the fourth quarter. Revenues for the two Bourbon Street locations remain substantially below pre-Katrina levels. Historically, our New Orleans locations generate a significant amount of our revenues. As of December 31, 2006, we operated 19 retail locations and, as of December 31, 2007, we operated 17 retail locations, including the San Francisco location that was closed in January 2008. See “Description of Business; General” above.

Costs of goods as a percentage of revenues decreased from approximately 24.8% during 2006 to approximately 23.4% during 2007. Management projected costs of goods as a percentage of revenues to increase in the year 2007. However, management increased prices of its sterling silver and gold inventories as those commodity markets rose, reduced purchases, primarily of gold inventory and reduced inventory overall, resulting in slightly lower cost of good sold in 2007.

During the year ended December 31, 2007, selling, general and administrative expenses decreased when compared to the year ended December 31, 2006 by \$629,307 (approximately 12.2%). As a percentage of sales, selling, general and administrative expenses decreased from approximately 84.5% during the year ended December 31, 2006 to approximately 81.5% during the year ended December 31, 2007. This decrease was primarily the result of closing non-performing locations. Excluding insurance payments received for damages in New Orleans, as a percentage of sales, selling, general and administrative expenses would have increased from approximately 81.3% during the twelve months ended December 31, 2006 to approximately 81.5% during the twelve months ended December 31, 2007.

#### Revenues Same Store Locations.

As of December 31, 2007, we operated the following 14 locations that were also in operation at December 31, 2006 and open for a full 12 months:

#### **California**

Monterey (three stores),  
Palm Springs,  
Sacramento,  
San Diego and  
San Francisco

**Colorado**

Vail

**Florida**

Sarasota

**Hawaii**

Wailea

**Louisiana**

New Orleans (Cardinal Gallery &amp; Elegant Illusions)

**Missouri**

Branson

**Nevada**

Laughlin

Revenues from same store locations for the year ended December 31, 2007, decreased approximately 0.28% from the same period in 2006. However, same store sales for the quarter ending December 31, 2007 were down 10.4% from the same period in 2006. Management believes that this decrease resulted from overall reduction in growth consumer spending and the effect of commodity prices on our products.

**Net Income**

During the year ended December 31, 2007, we realized a net loss of \$398,808 compared to net loss of \$527,007 for the year ended December 31, 2006.

**Inventory Turnover Ratios**

During the year ended December 31, 2007, we maintained an inventory that provided a turnover ratio of 0.27 to 1. This is the result of a reduction in Company revenues and a small decrease in inventory. Management does not believe that the current inventory turnover is indicative of impaired or slow-moving inventory. Management believes that the current inventory turnover ratio of 0.27 to 1 is appropriate in the current business climate, including maintaining our strategy of replacing inventory sold at our retail locations within a 2-3 day time frame. As wholesale revenues grow, management expects the inventory turnover ratio to improve, however this could be offset by store closings. Management reviews items on hand, on a regular basis, to determine slow moving items, then discount the price of those items so they are sold at prices that still generate a positive gross margin. The inventory turnover ratio for the year ended December 31, 2006 was 0.35 to 1.

**Liquidity and Capital Resources**

As of December 31, 2007, we had \$625,695 in cash and cash equivalents (compared to \$947,258 on December 31, 2006) and our current assets exceeded our current liabilities by \$4,989,447.

On August 17, 2006, we obtained a line of credit with Comerica Bank in the amount of \$1,000,000. Amounts borrowed under the line are now all due and payable June 1, 2008, interest is due monthly. Interest is at a variable rate at either 2.25% above the LIBOR rate or the bank's cost of funds as defined in the credit line agreement, at our option. The current interest rate at December 31, 2007 is 6.5625%. Borrowings under this line are secured by all of our assets. We are required to maintain certain financial ratios and covenants. If we do not maintain these ratios and covenants, the bank can accelerate the debt and proceed against the collateral. In the event that we default under the credit line, the default interest rate is 3% above the normal interest rate. As of December 31, 2007, our balance on this credit line was \$500,000 and as of January 30, 2008 the balance was \$200,000.

In September 2006, the Company signed an agreement with GE Money to finance customer purchases, interest free, from 90 days to 12 months based on the amount purchased.

### Effects Of Hurricane Katrina

All three New Orleans locations were closed effective August 29, 2005. The two Bourbon Street locations re-opened December 2, 2005 and the Riverwalk location re-opened October 12, 2007.

Our business in New Orleans is highly dependent on tourist foot traffic. The Bourbon Street and Riverwalk locations are open with limited operating hours. We anticipate closing the Bourbon Street locations and, operating hours at the Riverwalk location will remain limited until such time as foot traffic returns to pre-Katrina levels, if at all.

Store expansion is not our primary focus. Our primary anticipated capital expenditure during the year ending December 31, 2008 will be the expansion of our wholesale business by planning to attend national jewelry tradeshows in the USA, Canada and Europe and revising our jewelry concept at two of our locations to include new showcases, carpet, signage, additional products not currently offered in the Elegant Illusions concept and, possibly, a new trade name. We anticipate that we will incur certain costs associated with training staff in the new products and new procedures.

We believe that we have sufficient capital reserves for the foregoing activities.

### Off-Balance Sheet Transactions

We do not have any transactions, agreements or other contractual arrangements that constitute off-balance sheet arrangements.

### Application Of Critical Accounting Policies

Financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us relate to impairment of long-lived assets, and the costing of inventory as it relates to obsolescence and marketability.

Actual results could differ from those estimates. For example, unexpected changes in market conditions or a downturn in the economy could adversely affect actual results. Estimates are used in accounting for, among other things, inventory obsolescence, depreciation, taxes, and contingencies. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the Consolidated Financial Statements in the period they are determined to be necessary.

Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its Consolidated Financial Statements.

Merchandise Inventories. Merchandise Inventories are stated at the lower of cost or market. Management is constantly reviewing the turnover of individual items to determine if adjustments in pricing are required to affect the sales of said products. Substantially all inventories represent finished goods which are valued using the first-in, first-out (FIFO) inventory method.

We also write down our inventory for discontinued, slow-moving and damaged inventory if required. This write-down is equal to the difference between the cost of inventory and its estimated market value based upon assumptions of targeted inventory turn rates, future demand, management strategy, and market conditions. If actual market conditions are less favorable than those projected by management, or management strategy changes, additional inventory write-downs may be required and, in the case of a major change in strategy or downturn in market conditions, such write-downs could be significant.

Shrinkage is estimated for the period from the last inventory date to the end of the fiscal year on a store by store basis. Such estimates are based on experience and the shrinkage results from the last physical inventory. Physical inventories are taken annually for all store locations and for the distribution warehouse. The shrinkage rate from the most recent physical inventory, in combination with historical experience, is the basis for providing a shrinkage reserve if required.

Long-lived Assets. Long-lived assets are periodically reviewed for impairment by comparing the carrying value of the assets with their estimated fair values. If the evaluation indicates that the carrying amount of the asset may not be recoverable, the potential impairment is measured based on a projected discounted cash flow method, using a discount rate that is considered to be commensurate with the risk inherent in our current business model. Assumptions are made with respect to cash flows expected to be generated by the related assets based upon updated projections. Any changes in key assumptions or market conditions could result in an unanticipated impairment charge. For instance, in the event of a major market downturn, individual stores may become unprofitable, which could result in a write-down of the carrying value of the assets located in those stores. Any impairment would be recognized in operating results if a permanent reduction were to occur.

Revenue Recognition. We recognize revenue in accordance with the Securities and Exchange Commissions Staff Accounting Bulletin No. 101 Revenue Recognition in Financial Statements (SAB 101). Revenue related to merchandise sales is recognized at the time of the sale, reduced by a provision for returns. The provision for sales returns is based on historical evidence of our return rate.

Income Taxes Income taxes are estimated for each jurisdiction in which we operate. This involves assessing the current tax exposure together with temporary differences resulting from differing treatment

of items for tax and accounting purposes. Any resulting deferred tax assets are evaluated for recoverability based on estimated future taxable income.

### Issues And Uncertainties

The risks and uncertainties discussed in “*Cautionary Statement on Forward-Looking Statements*” above, among others, should be considered in evaluating our financial outlook.

### Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

There have been no changes in, or disagreements with our independent accountants with respect to accounting and/or financial disclosure, during the past two fiscal years.

### Directors and Executive Officers

The following table sets forth certain information concerning our directors and executive officers:

<u>Name</u>	<u>Age</u>	<u>First Became Director</u>	<u>Position</u>
James Cardinal	61	1993	Chief Executive Officer & Director
Gavin Gear	56	1993	President & Director
Tamara Gear	49	1993	Secretary-Treasurer & Director
Janet Heinze	59	1998	Director

Directors are elected at the meeting of stockholders called for that purpose and hold office until the next stockholders meeting called for that purpose or until their resignation or death. Officers of the Company are elected by the directors at meetings called by the directors for its purpose. The Company no longer is a reporting issuer under the Securities Exchange Act of 1934 and its securities are not traded on a national exchange. Accordingly, the Company is not required to have, and does not have, an audit committee or an audit committee financial expert.

JAMES CARDINAL has been the Company’s Chief Executive Officer since May 1994 and a director of the Company since May 1993. He was President of the Company from May 1993 to May 1994. He has been a director of the Company's wholly-owned California Subsidiary, Elegant Illusions, Inc. (the "Subsidiary") since 1992 and a business consultant for Subsidiary since 1989. He was a director of Bay Area Grand Illusions, Inc. ("Bay") from June 1992 until its merger in to the Subsidiary. Prior thereto, he was self-employed as a business consultant and capital organizer to start-up companies.

GAVIN GEAR has been the Company's President since May 1994 and a director of the Company since May 1993. He was Vice President of the Company from May 1993 to May 1994. He was a founder and has been the President, Chief Financial Officer and a director of the Subsidiary since 1989. Mr. Gear was President, Chief Financial Officer and a director of Copy Jewels, Inc. ("CJI") from 1989 until its merger into the Subsidiary and President and a director of Bay from 1988 until its merger into the Subsidiary. Since 1979, he also has been the President, Chief Financial Officer and a director of Cannery Row Enterprises, Inc. ("CRE"). CRE was acquired by the Company in July 1994.

TAMARA GEAR has been the Secretary-Treasurer and a director of the Company since May 1993. She was a founder and has been the Secretary-Treasurer and a director of the Subsidiary since 1989. She was the Secretary-Treasurer and a director of CJI (from 1989) and of Bay (from 1988) until their merger into the Subsidiary. Since 1985, she also has been an officer and director of CRE. From 1984 to 1985, Ms. Gear was a gemologist for Sun Studies in Carmel. From 1980 to 1984, she was the retail manager for Cannery Row Enterprises.

JANET HEINZE currently is the Superintendent at the American School in Guadalajara, Mexico. Prior thereto, she taught elementary school at the Park School in Hayward, California since September 1997. Ms. Heinze taught at the American School in Guadalajara, Mexico from September 1991 to August 1996. Ms. Heinze graduated from the University of California, Berkeley ("UCB") in 1969 with a degree in Sociology, received her teaching credentials at UCB in 1970 and her Masters degree from Framingham State University, Framingham, Massachusetts in 1996.

### Security Ownership of Certain Beneficial Owners and Management

The following table sets forth information with respect to the beneficial ownership of our Common Stock (excluding treasury stock) as of March 24, 2008 by: (i) each of our directors and executive officers; (ii) each person who is known by us to be the beneficial owner of five percent or more of the outstanding shares of Common Stock; and (iii) all of our directors and executive officers as a group:

<u>Name and Address of Beneficial Owner</u>	<u>Amount of Record and Beneficial Ownership</u>	<u>Percent of Class</u>
James C. Cardinal 542 Lighthouse Ave., Suite 5 Pacific Grove, CA 93950	2,115,673	35.3%
Gavin M. Gear 542 Lighthouse Ave., Suite 5 Pacific Grove, CA 93950	1,091,146(1)	18.2%
Tamara Gear 542 Lighthouse Ave., Suite 5 Pacific Grove, CA 93950	1,108,312(1)	18.5%
Janet Heinze CircunVaiaacion Nte 80 Las Fuentes 45070 Guadalajara, Jai Mexico	0	0%
All Officers and Directors as a Group (4 Persons)	4,315,131	72%

- (1) Gavin and Tamara Gear are husband and wife. Although each is deemed to be the beneficial owner of the shares held by the other, the shares listed for Gavin Gear do not include the shares owned by Tamara Gear and the shares listed for Tamara Gear do not include the shares owned by Gavin Gear.

### **Certain Relationships and Related Transactions**

During the fiscal years ended December 31, 2007 and 2006, there were no transactions to which we were a party, in which any executive officer, director, principal stockholder or immediate family member of any of the foregoing persons had a direct or indirect material interest, except as follows:

On June 12, 2003, the Company entered into a triple net lease for a condominium in New Orleans to house out-of-town managers and staff. Management determined that leasing an apartment was less costly than renting hotel rooms. James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company own the condominium. The specific lease terms require 12 monthly base payments of \$2,100 with the lease, as extended, expiring on July 31, 2008. Management believes that the lease terms for this condominium are comparable to those the Company would have obtained from an unaffiliated landlord.

On August 31, 2004, the Company entered into a triple net lease for a condominium in Vail to house its store manager. Management determined that leasing an apartment an incentive to hiring a manager. James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company own the condominium. The current specific lease terms require 12 monthly base payments of \$1,380 with the lease, as extended, expiring on July 31, 2007. Management believes that the lease terms for this condominium are comparable to those the Company would have obtained from an unaffiliated landlord.

Since June 2001, the Company has a triple net lease for its Cardinal Gallery in Sarasota, Florida. James Cardinal, Gavin Gear and Tamara Gear, executive officers, directors and principal stockholders of the Company own the store. The current lease terms require 12 monthly payments of \$5,330.85. This lease has been extended to July 31, 2008. Management believes that the lease terms for this store are comparable to those we would have obtained from an unaffiliated landlord.

## Financial Statements

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## **REPORT OF INDEPENDENT AUDITOR**

To the Board of Directors and Stockholders  
Elegant Illusions, Inc.

I have audited the accompanying consolidated balance sheets of Elegant Illusions, Inc. and Subsidiaries as of December 31, 2006 and 2007, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. My responsibility is to express an opinion on these financial statements based on my audits.

I conducted my audits in accordance with generally accepted auditing standards of the United States of America. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. 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. I believe that my audits provide a reasonable basis for my opinion.

In my opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Elegant Illusions, Inc. and Subsidiaries as of December 31, 2006 and 2007 and the consolidated results of operations, stockholders' equity and cash flows for the years then ended, in conformity with generally accepted accounting principles of the United States of America.

Los Angeles, California  
March 31, 2008

Jeffrey S. Gilbert, CPA

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

	December 31, <u>2006</u>	December 31, <u>2007</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$947,258	\$625,695
Accounts receivable	88,077	131,201
Income taxes receivable	59,602	0
Inventory	4,916,979	4,691,338
Prepaid expenses	<u>208,814</u>	<u>233,010</u>
TOTAL CURRENT ASSETS	6,220,730	5,681,244
PROPERTY AND EQUIPMENT, NET	1,235,991	1,141,226
DEFERRED TAX ASSETS, NET	194,398	318,000
OTHER ASSETS	<u>64,279</u>	<u>62,241</u>
	<u>\$7,715,398</u>	<u>\$7,202,711</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Current portion of long term debt	\$26,832	\$45,192
Due to Bank	500,000	500,000
Accounts payable and accrued expenses	<u>151,211</u>	<u>146,605</u>
TOTAL CURRENT LIABILITIES	<u>678,043</u>	<u>691,797</u>
<b>LONG TERM DEBT</b>		
Mortgage payable	<u>257,315</u>	<u>193,763</u>
TOTAL LIABILITES	<u>935,358</u>	<u>885,560</u>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock-authorized 10,000,000 shares, \$.001 per value, issued and outstanding 6,146,446 shares in 2006 and 2007	6,147	6,147
Additional paid in capital	3,914,509	3,914,509
Retained earnings	2,943,392	2,544,585
Less treasury stock at cost (62,067 and 153,612 shares in 2006 and 2007)	<u>(84,008)</u>	<u>(148,090)</u>
Total Stockholders' Equity	<u>6,780,039</u>	<u>6,317,151</u>
Total Liability and Stockholders' equity	<u>\$7,715,398</u>	<u>\$7,202,711</u>

See Accompanying Notes to Consolidated Financial Statements

**CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2007**

	<u>2006</u>	<u>2007</u>
REVENUES	\$6,101,290	\$5,552,754
COST OF GOODS SOLD	<u>1,513,585</u>	<u>1,301,755</u>
GROSS PROFITS	<u>4,587,705</u>	<u>4,250,999</u>
EXPENSES		
SELLING, GENERAL AND ADMINISTRATION	5,154,354	4,525,047
DEPRECIATION, AND AMORTIZATION	238,720	195,090
INTEREST EXPENSE	<u>30,638</u>	<u>57,669</u>
	<u>5,423,712</u>	<u>4,777,807</u>
INCOME (LOSS) BEFORE INCOME TAXES	(836,007)	(526,808)
PROVISION FOR INCOME TAXES	<u>(309,000)</u>	<u>(128,000)</u>
NET INCOME (LOSS)	<u>(\$527,007)</u>	<u>(\$398,808)</u>
WEIGHTED AVERAGE SHARES OUTSTANDING	<u>6,084,379</u>	<u>6,069,168</u>
BASIC AND DILUTED INCOME PER SHARE	<u>(\$0.09)</u>	<u>(\$0.07)</u>

See Accompanying Notes to Consolidated Financial Statements

ELEGANT ILLUSIONS, INC., AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDER'S EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2007

	Common Stock		Additional		Treasury	
	Shares		Paid-in	Retained	Stock	Total
	<u>Outstanding</u>	<u>Amount</u>	<u>Capital</u>	<u>Earnings</u>		
BALANCE, December 31, 2005	6,146,533	\$ 6,147	\$ 3,914,509	\$ 3,470,398	\$ (84,008)	\$ 7,307,046
Net Loss for the year	_____	_____	_____	<u>(527,007)</u>	_____	<u>(527,007)</u>
BALANCE December 31, 2006	6,146,533	6,147	3,914,509	2,943,392	(84,008)	6,780,040
Purchase of Treasury Stock					(64,082)	(64,082)
Net Loss for the year	_____	_____	_____	<u>(398,808)</u>	_____	<u>(398,808)</u>
BALANCE December 31, 2007	<u>6,146,533</u>	<u>\$ 6,147</u>	<u>\$ 3,914,509</u>	<u>\$ 2,544,584</u>	<u>\$ (148,090)</u>	<u>\$6,317,151</u>

See accompanying Notes to Consolidated Financial Statements

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2007**

	<u>2006</u>	<u>2007</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	(\$527,007)	(\$398,808)
Adjustments to reconcile net income To net cash provided by (used in) operating activities		
Depreciation and amortization	238,720	195,090
Abandonment of property and equipment	11,128	16,927
Changes in operating assets and liabilities		
(Increase) Decrease in :		
Accounts receivable	34,629	(43,124)
Inventory	(179,136)	225,641
Prepaid expenses	26,260	(24,197)
Income tax receivable	35,336	59,602
Deferred tax asset		
Increase (Decrease in)		
Accounts payable and accrued expenses	18,232	(4,606)
Deferred income taxes payable and assets	<u>(249,398)</u>	<u>(123,602)</u>
NET CASH PROVIDED BY OPERATIONS	<u>(591,236)</u>	<u>(97,077)</u>
CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(99,790)	(117,254)
Other assets	<u>9,131</u>	<u>2,039</u>
NET CASH USED IN INVESTING ACTIVITIES	<u>(107,679)</u>	<u>(115,215)</u>
CASH FLOW FROM FINANCING ACTIVITIES		
Bank Debt	500,000	0
Mortgages payable	<u>(45,192)</u>	<u>(45,192)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>454,808</u>	<u>(45,192)</u>
CASH FLOW USED IN INVESTING ACTIVITIES		
Treasury Stock		<u>(64,082)</u>
NET CASH USED IN INVESTING ACTIVITIES		<u>(64,082)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	(244,107)	(321,566)
CASH AND CASH EQUIVALENT BALANCE		
Beginning of period	<u>1,191,366</u>	<u>947,259</u>
CASH AND CASH EQUIVALENT BALANCE		
End of Period	<u>\$947,259</u>	<u>\$625,695</u>
SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest Paid	<u>\$30,638</u>	<u>\$57,669</u>
Income taxes paid	<u>0</u>	<u>\$0</u>

See Accompanying Notes to Consolidated Financial Statements  
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**ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2006 AND 2007**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Organization and Description of Business - Elegant Illusions, Inc. was incorporated in Delaware in March 1988. The Company is engaged in the retail sale of created gem at locations in California, Colorado, Nevada, Missouri, Louisiana, Hawaii and Florida. It also sells fine art and fine jewelry at some of these locations and sells fine jewelry at an additional location in California. Created gem jewelry items are replications of fine jewelry, manufactured with synthetic stones set in 14 carat gold, sterling silver vermeil or plated brass.

Principles of Consolidation - The financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated.

Cash and Cash Equivalents - Cash equivalents are purchased short-term highly liquid investments readily convertible to cash with original maturities of no more than three months. There are cash balances in certain Federal insured banks that exceed the maximum insured amounts. However, management of the Company does not consider this a significant risk. As of December 31, 2007, the Company has deposits in excess of the FDIC limit in the amount of approximately \$400,000.

Inventories - Inventories are stated at the lower of cost or market determined on a first-in, first-out (FIFO) basis.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Fair Value of Financial Instruments - The Company's financial instruments consists of cash equivalents, receivables, accounts payable, accrued expenses and notes. The fair values of the Company's financial instruments approximates the carrying value of the instruments.

Impairment of Long-Lived Assets - The Company periodically assesses the recoverability of the carrying amounts of long-lived assets, including intangible assets. A loss is recognized when expected undiscounted future cash flows are less than the carrying amount of the asset. The impairment loss is the difference by which the carrying amount of the assets exceeds its fair value. The Company does not expect to have any significant losses resulting from its review of impairment of long-lived assets. The loss on disposition of property and equipment relates to stores closed.

Stock-Based Compensation -

The Company has no stock option plan nor has it issued stock for compensation.

**ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued**

Property and Equipment - Property and equipment is stated at cost. Depreciation is computed on the straight-line method based upon the estimated useful life of the asset. Useful lives are generally as follows:

Office furniture, fixtures & equipment	5-7 years
Store furniture, fixtures & equipment	5-7 years
Leasehold improvements	5-7 years

Income Taxes - The Company utilizes the asset and liability method for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Basic and Diluted Loss per Share – Basic earnings per common share is based upon the net earnings divided by the weighted average number of common shares outstanding during the period. Diluted loss per common share adjusts for the effect of convertible securities, stock options and warrants, if applicable, only in the periods presented in which effect would have been diluted. The Company did not grant options and warrants during 2006 and 2007 and there are no outstanding convertible securities, options and warrants as of December 31, 2006 and 2007.

Start-up Costs - Costs of start-up activities, including organization costs, is expensed as incurred.

Revenue – Revenues related to the sale of jewelry and art are recognized at the time the items are delivered to the customer.

Advertising - Advertising costs are expensed the first time the advertisement is run. Total advertising and promotion expenses were approximately \$243,000 and \$210,000 for the years ended December 31, 2006 and 2007, respectively.

**2. PROPERTY AND EQUIPMENT**

Property and equipment consisted of the following at December 31, 2006 and 2007:

	2006	2007
Real Estate	\$ 759,940	\$ 759,940
Office furniture, fixtures & equipment	404,443	442,064
Store furniture, fixtures & equipment	2,195,550	2,139,606
Vehicles	147,571	147,571
Leasehold improvements	744,638	744,273
	4,252,142	4,233,454
Less: accumulated depreciation and amortization	3,016,151	3,092,228
	\$ 1,235,991	\$1,141,226

**ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued**

**3. INCOME TAXES**

The components of income tax expense for the years ended December 31, 2006 and 2007 follow:

	<u>Federal</u>	<u>State</u>	<u>Total</u>
2006			
Current	\$ (110,181)	\$	\$ (110,181)
Deferred	<u>(142,819)</u>	<u>(56,000)</u>	<u>(198,819)</u>
	<u>\$ (253,000)</u>	<u>\$ (56,000)</u>	<u>\$ (309,000)</u>
2007:			
Current	<u>\$ (93,000)</u>	\$ (35,000)	\$ (128,000)
Deferred	<u>\$ (93,000)</u>	<u>\$ (35,000)</u>	<u>\$ (128,000)</u>

The deferred tax asset comprises the estimated future tax benefit of the net operating tax loss carry forward arising during the current and prior year.

Utilization of this tax asset is dependent on the future taxable profits. Although there was a reported loss for the two years ended December 31, 2007, management expects a turnaround over the next two years and the ability to utilize the tax loss carry forward.

The net deferred asset includes an offset for deferred tax liability related to depreciation.

Income tax expense amounted to \$(309,000) in 2006 and \$(128,000) in 2007 (effective tax rates of 37% and 24%, respectively). The actual tax expense differs from the expected tax expense (computed by applying the Federal corporate tax rate of 34% to earnings before income taxes) as follows:

	<u>2006</u>	<u>2007</u>
Expected statutory tax (benefit)	\$ (284,242)	(179,000)
State income tax, net of federal tax benefit	(37,968)	(23,706)
Other	1,460	63,071
Impact from initial lower Federal Tax rates	<u>11,750</u>	<u>11,750</u>
Actual tax (benefit)	<u>\$ (309,000)</u>	<u>\$ (128,000)</u>

The Company has Federal and State net operating loss carry forwards of \$896,000 and \$744,000 respectively. The Federal and State net operating loss carries forwards begin expiring in 2025 and 2015 respectively.

**4. OPERATING LEASES**

The Company leases its office and retail store facilities and certain equipment under operating leases with terms ranging from three to five years. Certain of the leases include percentage rates of 3% to 12% of revenues as defined. The Company has placed with various lessors approximately \$60,000 in deposits as required by the leases as of December 31, 2007.

Future minimum lease payments by year and in the aggregate, under non-cancelable operating leases with initial or remaining lease terms in excess of one year, as of December 31, 2007 are as follows:

Year Ended <u>December 31,</u>	
2008	\$ 700,000
2009	451,000
2010	208,000
2011	92,000
2012	<u>48,000</u>
	<u>\$ 1,499,000</u>

Rent expense for the fiscal years ended December 31, 2006 and 2007 were \$1,260,155 and \$1,038,541.

During 2001, the Company entered into a lease arrangement with its three major shareholders to lease a store location in Sarasota, Florida. In the opinion of Management the lease is at market value for that location. The specific lease terms required 60 monthly base payments of \$7,200. This lease was renewed through July 31, 2008, with 12 monthly base payments of \$5,330.85. In additions those same majority shareholders have leased two condominium locations that they own near existing store locations that are used by management in lieu of hotels. The terms of the leases require aggregate monthly payment of \$3,480.

## 5. BANK DEBT AND LONG TERM DEBT

The Company has established a bank line of credit to allow it to borrow up to \$1,000,000. Amounts borrowed under the line are now all due and payable June 1, 2008, interest is due monthly. Interest is at a variable rate at either 2.25% above the LIBOR rate or the bank's cost of funds as defined in the credit line agreement, at the Company's option. The current interest rate at December 31, 2006 is 6.565%. Borrowings under this line are secured by all of the Company's assets. The Company is required to maintain certain financial ratios and covenants. If it does not maintain these ratios and covenants, the bank can accelerate the debt and proceed against the collateral. In the event that the Company defaults under the credit line, the default interest rate is 3% above the normal interest rate. As of December 31, 2007, the balance on this credit line was \$500,000

The Company owns a sales location in Vail, Colorado. It purchased the property for approximately \$595,000 of which \$480,000 of the purchased price was funded by a mortgage note secured by the property at 8.96% per annum. The mortgage was modified effective April 2003 reducing the interest rate to the bank's cost of funds plus 2.25% (as of December 31, 2007 the rate was 6.4375%). The mortgage is stated at fair value. The Company is now required to make monthly principal payments of \$3,766 plus interest for 120 months. Estimated principal repayments over the next five years are as follows:

2008	\$45,192
2009	\$45,192
2010	\$45,192
2011	\$45,192
2012	<u>\$45,192</u>

**ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued**

**6. SAVINGS PLAN – 401(k)**

The Company, effective June 1, 2001 established a 401(k) profit sharing plan. For eligible employees, the Company savings and investment plan will allow eligible employees to allocate up to 20% of salary, up to the legal limit of \$52,000 of payroll, through payroll deductions. The Company matches 60% of the employee's pre-tax contributions, up to plan limits. In 2006 and 2007, the costs of this plan was approximately \$52,000 and \$44,000, respectively.

**7. TREASURY STOCK**

During the current year the Company acquired 91,545 shares of it's common stock for \$64,082.

SIGNATURE

TITLE

DATE

\_\_\_\_\_  
James Cardinal

Chief Executive Officer  
and Director

May 5, 2008