

## QUARTERLY REPORT

For the quarterly period ended June 30, 2007

of

ELEGANT ILLUSIONS, INC.

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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 a quarterly report on Form 10-QSB.**

## **FINANCIAL INFORMATION**

### **Financial Statements**

The accompanying financial statements are unaudited for the interim periods, but include all adjustments (consisting only of normal recurring accruals), which our management considers necessary for the fair presentation of results for the three and six months ended June 30, 2007.

Moreover, these financial statements do not purport to contain complete disclosure in conformity with generally accepted accounting principles and should be read in conjunction with our audited financial statements at, and for the fiscal year ended December 31, 2006. If you would like a copy of such audited financial statements, please contact us and we will send them to you free of charge.

The results reflected for the three and six months ended June 30, 2007 are not necessarily indicative of the results for the entire fiscal year.

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	December 31, <u>2006</u>	June 30, <u>2007</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$947,258	\$656,559
Accounts receivable	88,077	136,928
Income taxes receivable	59,602	51,793
Inventory	4,916,979	4,828,261
Prepaid expenses	<u>208,814</u>	<u>224,309</u>
TOTAL CURRENT ASSETS	6,220,730	5,897,850
PROPERTY AND EQUIPMENT, NET	1,235,991	1,167,115
DEFERRED TAX ASSETS, NET	194,398	294,207
OTHER ASSETS	<u>64,279</u>	<u>59,741</u>
	<u>\$7,715,398</u>	<u>\$7,418,913</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Current portion of long term debt	\$26,832	\$29,187
Due to Bank	500,000	500,000
Accounts payable and accrued expenses	<u>151,211</u>	<u>161,695</u>
TOTAL CURRENT LIABILITIES	<u>678,043</u>	<u>690,882</u>
<b>LONG TERM DEBT</b>		
Mortgage payable	257,315	232,364
Deferred income taxes	<u>0</u>	<u>0</u>
	<u>257,315</u>	<u>232,364</u>
TOTAL LIABILITIES	<u>935,358</u>	<u>923,246</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	2,659,020
Less treasury stock at cost (62,067 shares in 2006 and 2007)	<u>(84,008)</u>	<u>(84,008)</u>
	<u>6,780,039</u>	<u>6,495,667</u>
	<u>\$7,715,398</u>	<u>\$7,418,913</u>

See Accompanying Notes to Consolidated Financial Statements  
**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES**

**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2007**  
**(Unaudited)**

	<u>2006</u>	<u>2007</u>
REVENUES	\$2,882,793	\$2,704,217
COST OF GOODS SOLD	<u>742,488</u>	<u>618,690</u>
GROSS PROFITS	<u>2,140,305</u>	<u>2,085,527</u>
EXPENSES		
SELLING, GENERAL AND ADMINISTRATION	2,456,631	2,340,623
DEPRECIATION, AND AMORTIZATION	115,848	91,735
INTEREST EXPENSE	<u>11,054</u>	<u>29,542</u>
	<u>2,583,533</u>	<u>2,461,900</u>
INCOME (LOSS) BEFORE INCOME TAXES	(443,228)	(376,373)
PROVISION FOR INCOME TAXES	<u>(171,000)</u>	<u>(92,000)</u>
NET INCOME (LOSS)	<u>(\$272,228)</u>	<u>(\$284,373)</u>
WEIGHTED AVERAGE SHARES OUTSTANDING	<u>6,084,379</u>	<u>6,084,379</u>
BASIC AND DILUTED INCOME PER SHARE	<u>(\$0.04)</u>	<u>(\$0.05)</u>

See Accompanying Notes to Consolidated Financial Statements

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2007**  
**(Unaudited)**

	<u>2006</u>	<u>2007</u>
REVENUES	\$1,480,408	\$1,371,235
COST OF GOODS SOLD	<u>340,925</u>	<u>335,528</u>
GROSS PROFITS	<u>1,139,483</u>	<u>1,035,707</u>
EXPENSES		
SELLING, GENERAL AND ADMINISTRATION	1,310,920	1,212,045
DEPRECIATION, AND AMORTIZATION	58,568	45,399
INTEREST EXPENSE	<u>5,672</u>	<u>14,808</u>
	<u>1,375,160</u>	<u>1,272,252</u>
INCOME (LOSS) BEFORE INCOME TAXES	(235,677)	(236,545)
PROVISION FOR INCOME TAXES	<u>(91,000)</u>	<u>(28,000)</u>
NET INCOME (LOSS)	<u>(\$144,677)</u>	<u>(\$208,545)</u>
WEIGHTED AVERAGE SHARES OUTSTANDING	<u>6,084,379</u>	<u>6,084,379</u>
BASIC AND DILUTED INCOME PER SHARE	<u>(\$0.02)</u>	<u>(\$0.03)</u>

See Accompanying Notes to Consolidated Financial Statements

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
**FOR THE SIX MONTHS ENDED JUNE 30 2007 AND 2007**  
**(unaudited)**

	<u>2006</u>	<u>2007</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	(\$272,227)	(\$284,373)
Adjustments to reconcile net income To net cash provided by (used in) operating activities		
Depreciation and amortization	28,568	91,735
Abandonment of property and equipment	0	25,720
Changes in operating assets and liabilities (Increase) Decrease in :		
Accounts receivable	59,804	(48,852)
Inventory	(144,440)	88,718
Prepaid expenses	(70,058)	(15,495)
Income tax receivable	(98,964)	7,809
Deferred tax asset		(99,809)
Increase (Decrease in) Accounts payable and accrued expenses	<u>12,309</u>	<u>10,484</u>
NET CASH PROVIDED BY OPERATIONS	<u>(455,008)</u>	<u>(224,063)</u>
CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(33,742)	(48,581)
Other assets	<u>(242)</u>	<u>4,540</u>
NET CASH USED IN INVESTING ACTIVITIES	<u>(33,984)</u>	<u>(44,040)</u>
CASH FLOW FROM FINANCING ACTIVITIES		
Bank Debt		0
Mortgages payable	<u>(22,596)</u>	<u>(22,596)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(22,596)</u>	<u>(22,596)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	(511,588)	(290,699)
CASH AND CASH EQUIVALENT BALANCE		
Beginning of period	<u>1,191,366</u>	<u>947,258</u>
CASH AND CASH EQUIVALENT BALANCE		
End of Period	<u>\$679,778</u>	<u>\$656,559</u>
SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest Paid	<u>\$11,054</u>	<u>\$29,542</u>
Income taxes paid	<u>0</u>	<u>\$0</u>

See Accompanying Notes to Consolidated Financial Statements

**ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. COMMENTS**

The accompanying unaudited consolidated condensed financial statements, which are for interim periods, do not include all disclosure provided in the annual consolidated financial statements. These unaudited consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto contained in the Annual Report for the year ended December 31, 2006 of Elegant Illusions, Inc (the "Company"). The December 31, 2006 consolidated condensed balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (which are of a normal recurring nature) necessary for a fair presentation of the financial statements. The results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the full fiscal year.

## **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 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) 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 the fourth 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

#### Three and Six Months Ended June 30, 2007 Compared to Three and Six Months Ended June 30, 2006

Sales for the three months ended June 30, 2007 decreased \$109,173 or approximately 7.4% when compared to the three months ended June 30, 2006. Sales for the six months ended June 30, 2007 decreased \$178,576 or approximately 6.2% when compared to the six months ended June 30, 2006.

Management believes that these decreases in Company wide sales were a result of the closing of five locations that were in operation during the first quarter of 2006, the continuing

effects of Hurricane Katrina (see “Effects of Hurricane Katrina” below), offset by an increase in same store sales at locations open more than a year (see “Revenues Same Store Locations” below). Historically, our New Orleans locations generate a significant amount of our revenues. As of June 30, 2006, we operated 21 retail locations and, as of June 30, 2007, we operated 16 retail locations, excluding the Riverwalk location.

Costs of goods as a percentage of revenues increased from approximately 23.03% during second quarter of 2006 to approximately 24.5% during the second quarter of 2007. Cost of goods as a percentage of revenues for the six months ending June 30, 2006 decreased from approximately 25.8% to approximately 22.9% during the six months ended June 30, 2007. Management believes that the increase in cost of goods in the second quarter is the result of slightly higher discounts, in spite of higher gross margins due, in part, to increased prices of our goods.

During the three months ended June 30, 2007, selling, general and administrative expenses decreased when compared to the three months ended June 30, 2006 by \$98,875 (approximately 7.5%). As a percentage of sales, selling, general and administrative expenses decreased from approximately 88.6% during the three months ended June 30, 2006 to approximately 88.4% during the three months ended June 30, 2007. Management believes this decrease is a function of closing locations, offset by costs for abandonment of assets, the result of the expenses related to closing of the Miromar and Philadelphia locations. Excluding the insurance payments, as a percentage of sales, selling, general and administrative expenses would have decreased from approximately 92.5% during the three months ended June 30, 2006 to approximately 88.3% during the three months ended June 30, 2007.

During the six months ended June 30, 2007, selling, general and administrative expenses decreased when compared to the six months ended June 30, 2006 by \$116,008 (approximately 4.7%). However, as a percentage of sales, selling, general and administrative expenses increased from approximately 85.2% during the six months ended June 30, 2006 to approximately 86.6% during the six months ended June 30, 2007. Management believes the decrease in these expenses during the six months ended June 30, 2007 is a function of the closing of five locations. Excluding the insurance payments, as a percentage of sales, selling, general and administrative expenses would have decreased from approximately 91.8% during the six months ended June 30, 2006 to approximately 86.5% during the six months ended June 30, 2007.

#### Revenues Same Store Locations.

As of June 30, 2007, we operated 15 locations that were also in operation at June 30, 2006: two in New Orleans, three in Monterey, one in Sacramento, one in San Diego, one in San Francisco, one in Palm Springs, one in Branson, one in Laughlin, one in Sarasota, one in Wailea, Hawaii, one in Lahaina, Hawaii and one in Vail.

Revenues from these locations for the quarter ended June 30, 2007, increased approximately 4.9% from the same period in 2006. Revenues from these locations for the six months ending June 30, 2007 increased approximately 6.3% from the same period in 2006.

Management believes this increase in same store revenues is the result of improving foot-traffic at most locations including the two New Orleans locations, mild weather, an increase in higher than “average ticket” sales and increased revenues from the Company’s private label Credit Card program instituted in September 2006 (see “Liquidity and Capital Resources” below) .

### Net Loss

During the three months ended June 30, 2007, we realized a net loss of \$208,545 compared to a net loss of \$144,677 for the three months ended June 30, 2006. During the six months ended June 30, 2007, we realized a net loss of \$284,373 compared to a net loss of \$272,228 for the six months ended June 30, 2006. The loss of 272,228 for the six months ended June 30, 2006 was mitigated by insurance payments in the amount of \$190,188, the result of Hurricane Katrina. Excluding these non-recurring payments, the Company’s net losses for the three and six months ended June 30, 2006 would have been significantly greater.

Management expects losses to continue through to the third quarter of 2007 and possibly beyond.

### Inventory Turnover Ratios

During the three months ended June 30, 2007, we maintained an inventory that provided a turnover ratio of 0.3 to 1. We believe that this inventory turnover ratio is appropriate for our plan of operation, including maintaining our strategy of replacing inventory sold at our retail locations within a 2-3 day time frame. We review 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 three months ended June 30, 2006 was 0.3 to 1.

### Liquidity and Capital Resources

As of June 30, 2006, we had \$656,559 in cash and cash equivalents, a decline of \$290,699 from December 31, 2006, and our current assets exceeded our current liabilities by \$5,206,968, a decline of \$335,719 from December 31, 2006, primarily resulting from our net loss during the six months ending June 30, 2007.

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 all due and payable March 1, 2008, interest is due monthly. As of June 30, 2007, our balance on this credit line was \$500,000.

In September 2006, the Company switched to a new private label credit card provider. Revenues under the new private label credit card provider for the six months ending June 30, 2007 increased 101% over the same period in 2006.

### 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; however the Riverwalk location remains closed and management is currently in negotiations with the Riverwalk Marketplace Mall manager to re-open this store. Management does not know when or if the Riverwalk location will re-open. Management has also estimated certain costs for restoring the Riverwalk location of approximately \$24,000. Management cannot be certain if actual restoration costs will exceed this amount.

Our business in New Orleans is highly dependent on tourist foot traffic. Tourist foot traffic, the Convention Center and the Cruise Ship businesses are substantially below pre-Katrina levels. The Bourbon Street locations are open with limited operating hours until such time as foot traffic returns to pre-Katrina levels, if at all. Management cautions it has no specific date for when the Riverwalk location will re-open.

Although we closed three locations in 2006, two in the first quarter of 2007 and have not renewed our Lahaina Cannery lease, we continue to look for potential new store locations. However, store expansion is not our primary focus. Our Primary focus is on operating controls and costs.

Our primary anticipated capital expenditure during the year ending December 31, 2007 will be the opening of possibly one to two additional created gem jewelry stores.

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 events or changes in market conditions or a downturn in the economy could adversely affect actual results. Hurricane Katrina was a good example of a material unexpected event. 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 tax benefits 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.

#### **Other Information**

None during the quarter ended June 30, 2007.