BROADWING INC
Form DEF 14A
March 28, 2002

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SCHEDULE 14A
(RULE 14a-101)

INFORMATION REQUIRED IN PROXY STATEMENT
SCHEDULE 14A INFORMATION

PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant þ

Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement
o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
þ Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to Section 240.14a-11c or Section 240.14a-12

Broadwing Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.

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(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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o Fee paid previously with preliminary materials.

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

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(4) Date Filed:

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Broadwing Inc.

201 East Fourth Street
P. O. Box 2301
Cincinnati, Ohio 45202

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD APRIL 29, 2002

To Our Shareholders:

The 2002 Annual Meeting of Shareholders of Broadwing Inc. (the Company) will be held on Monday, April 29, 2002 at 11:00 a.m. Eastern Time at the Northern Kentucky Convention Center, One W. RiverCenter Blvd., Covington, Kentucky 41011 for the following purposes:

1. To elect three (3) Class III directors to serve three-year terms ending in 2005; and

2. Consider any other matters that may properly come before the meeting or any adjournments or postponements of the meeting.

The Board of Directors has established the close of business on March 5, 2002, as the record date (the Record Date) for determining the shareholders entitled to notice of, and to vote at, the Annual Meeting or any adjournment or postponement of the meeting. Only shareholders of record at the close of business on the Record Date are entitled to vote on matters to be presented at the Annual Meeting.

YOUR VOTE IS IMPORTANT. PLEASE TAKE A FEW MINUTES TO READ THE ENCLOSED MATERIAL AND VOTE YOUR SHARES. YOU CAN VOTE BY THE INTERNET, BY TELEPHONE, OR BY MAILING YOUR COMPLETED AND SIGNED PROXY OR VOTING INSTRUCTION CARD(S) IN THE ENCLOSED POSTAGE-PAID ENVELOPE. IF YOU ARE SHAREHOLDER OF RECORD FOR YOUR SHARES, YOU CAN ALSO VOTE AT THE ANNUAL MEETING.

Your prompt response will also help reduce proxy costs and will help you avoid receiving follow-up telephone calls or mailings. Voting by the Internet or telephone will help reduce proxy costs even further.

We have enclosed the Proxy Statement with this notice of the Annual Meeting.

By Order of the Board of Directors
/s/ Jeffrey C. Smith
Jeffrey C. Smith
Secretary

March 22, 2002

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BROADWING INC.

201 East Fourth Street

P.O. Box 2301
Cincinnati, Ohio 45202

PROXY STATEMENT

For the Annual Meeting of Shareholders

to be held on Monday, April 29, 2002

This Proxy Statement and the accompanying proxy or voting instruction card are furnished to the shareholders of Broadwing Inc., an Ohio corporation (the Company), in connection with the solicitation of proxies by the Board of Directors for use at the 2002 Annual Meeting of Shareholders. The Annual Meeting will be held on Monday, April 29, 2002, beginning at 11:00 a.m. Eastern Time at the Northern Kentucky Convention Center, One W. RiverCenter Blvd., Covington, Kentucky 41011. The Notice of Annual Meeting of Shareholders, this Proxy Statement, the accompanying proxy or voting instruction card, and the annual report of the Company for the year ended December 31, 2001 are first being mailed to the shareholders on or about March 29, 2002.

The Company s Board of Directors has established March 5, 2002, as the record date (the Record Date) for determining shareholders entitled to vote at the Annual Meeting or any adjournment or postponement of the Annual Meeting. Only shareholders of record at the close of business on the Record Date will be entitled to vote on matters to be presented at the Annual Meeting.

The agenda for the Annual Meeting is as follows:

1. Elect three (3) Class III directors to serve three-year terms ending in 2005; and

2. Consider any other matters that may properly come before the meeting or any adjournments or postponements of the meeting.

PLEASE VOTE YOUR VOTE IS IMPORTANT

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Broadwing Inc. is a full-service local and national provider of data and voice communications services, and a regional provider of wireless communications services. The Company seeks to provide world-class service on a national level by combining two sets of strengths: its national optical network and Internet backbone and its state-of-the-art local network with a well-regarded brand name and reputation for service. The Company operates in four business segments: Broadband, Local, Wireless and Other.

QUESTIONS AND ANSWERS ABOUT THE PROXY MATERIALS AND THE ANNUAL MEETING

Q: **Why am I receiving these proxy materials?**

A: The Company s Board of Directors (the Board) is providing these proxy materials to you in connection with the Annual Meeting of Shareholders, which will take place on April 29, 2002. As a shareholder, you are invited to attend the meeting and are entitled to vote on the proposal described in this Proxy Statement.

Q: **What information is contained in these materials?**

A: This Proxy Statement includes information relating to the proposal to be voted on at the meeting, the voting process, the compensation of directors and certain officers, and certain other information required by the rules and regulations of the Securities and Exchange Commission. Also enclosed is a proxy card or voting instruction card for your use in voting. Our 2001 Annual Report, including our full 2001 consolidated financial statements, is also enclosed.

Q: **What proposals will be voted on at the meeting?**

A: There is one proposal scheduled to be voted on at the meeting:
The election of three (3) Class III directors to serve three-year terms ending in 2005.

Q: **What is Broadwing s voting recommendation?**

A: The Board recommends that you vote your shares FOR each of the nominees to the Board.

Q: **What shares can I vote?**

A: You may vote all Company common shares and 6 3/4% Cumulative Convertible Preferred Shares that you own as of the close of business on the Record Date. These shares include: (1) shares held directly in your name as the shareholder of record, including common shares purchased through Broadwing s Employee Stock Ownership Plan (ESOP), Employee Stock Purchase Plan (ESPP), Retirement Savings Plan, or Savings and Security Plan and credited to your account under any of such plans; and (2) shares held for you as the beneficial owner through a stockbroker or bank.

Q: **What is the difference between holding shares as a shareholder of record and as a beneficial owner?**

A: Many Broadwing shareholders hold their shares through a stockbroker, bank or other nominee rather than directly in their own name. As summarized below, there are some distinctions between shares held of record and those owned beneficially.

Shareholder of Record

If your shares are registered directly in your name with Broadwing s transfer agent, The Fifth Third Bank, you are considered the shareholder of record for those shares, and Broadwing is sending these proxy materials directly to you. As a shareholder of record, you may grant your voting proxy directly to Broadwing to vote your shares or vote your shares in person at the meeting. Broadwing has enclosed a proxy card for your use in voting by proxy.

Beneficial Owner

If your shares are held in a stock brokerage account or by a bank or other nominee, you are considered the beneficial owner of shares held in street name, and your broker or nominee is considered to be the shareholder of record. If you are a beneficial owner, your broker or nominee has forwarded these proxy materials to you. As the beneficial owner, you may direct your broker to vote, and are also invited to attend the meeting.

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However, since you are not the shareholder of record, you may not vote these shares in person at the meeting unless you obtain a signed proxy from the record holder giving you the right to vote the shares. Your broker or nominee has provided a voting instruction card for you to use in directing the broker or nominee on how to vote your shares.

Q: **How can I vote my shares at the meeting?**

A: Shares held directly in your name as the shareholder of record may be voted in person at the Annual Meeting. Shares you own beneficially, in street name, cannot be voted at the Annual Meeting unless you obtain a proxy from the shareholder of record authorizing you to vote these shares at the Annual Meeting. If you choose to attend the meeting and vote in person, please bring the enclosed proxy card and proof of identification.

Q: **How can I vote my shares without attending the meeting?**

A: Whether you hold shares directly as the shareholder of record, or beneficially in street name, you may direct your vote without attending the meeting. For shares held directly as the shareholder of record, you may vote by granting a proxy. For shares held in street name, you may vote by submitting voting instructions to your broker or nominee. You may also vote over the Internet, or by telephone. Please refer to the summary instructions below and those included on your proxy or voting instruction card.

By Internet If you have Internet access, you may submit your vote from any location by following the Vote by Internet instructions on your proxy or voting instruction card.

By telephone If you live in the United States or Canada, you may submit your vote by following the Vote by Phone instructions on the proxy card.

By mail You may vote by mail by completing and signing your proxy or voting instruction card and mailing it in the accompanying enclosed, pre-addressed envelope.

Q: **Can I change my vote?**

A: Yes. You may change your voting instructions at any time prior to the vote at the Annual Meeting. For shares you hold as the shareholder of record, you may change your vote by either: (i) granting a new proxy bearing a later date (which automatically revokes the earlier proxy); (ii) by notifying the Company s Secretary in writing that you want to revoke your earlier proxy; or (iii) attending the Annual Meeting, giving notice of your proxy revocation in open meeting and voting in person. Note that mere attendance at the meeting will not cause your previously granted proxy to be revoked; at the Annual Meeting you must specifically request to revoke your previous proxy. For shares held beneficially by you in street name, you may change your vote by submitting new voting instructions to your broker or nominee.

Q: **How are votes counted?**

A: For the election of directors, you may vote FOR all of the nominees, or you may withhold your vote with respect to one or more of the nominees. To do so, you must follow the instructions on your proxy card or voting instruction card or, if voting by Internet or phone, by following the instructions when prompted. If you sign your proxy or broker voting instruction card and do not provide instructions concerning your vote, your shares will be voted in accordance with the recommendation of the Board (FOR all of the Company s nominees to the Board and in the discretion of the proxy holders on any other matters that properly come before the meeting), except that common shares you hold in the Retirement Savings Plan or the Savings and Security Plan will be voted by the trustees of such plans in proportion to the way voting plan participants vote their shares.

Q: **What is the voting requirement to approve the proposal?**

A: In the election of directors, the three persons receiving the highest number of FOR votes will be elected. If you are a beneficial owner and do not respond to your broker or nominee s request for voting instructions or do not sign your voting instruction card, your shares will constitute broker non-votes, as described in What is the quorum requirement for the meeting? below. In tabulating the voting result, broker non-votes are not

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considered entitled to vote. There are no cumulative voting rights for either the common shares or 6 3/4% Cumulative Convertible Preferred Shares.

Q: **What does it mean if I receive more than one proxy or voting instruction card?**

A: It means your shares are registered differently or are in more than one account. Please provide voting instructions for all proxy and voting instruction cards you receive.

Q: **Where can I find the voting results of the meeting?**

A: We will announce preliminary voting results at the meeting and publish final results in our quarterly report on Form 10-Q for the second quarter of fiscal year 2002**.**

Q: **What happens if additional proposals are presented at the meeting?**

A: Other than the proposal described in this Proxy Statement, we do not expect any matters to be presented for a vote at the Annual Meeting. If you grant a proxy, the persons named as proxy holders, Phillip R. Cox, Richard G. Ellenberger and William A. Friedlander, will have the discretion to vote your shares on any additional matters properly presented for a vote at the meeting. If for any unforeseen reason any of the nominees is not available as a candidate for director, the persons named as proxy holders will vote your proxy for such other candidate or candidates as may be nominated by the Board of Directors.

Q: **What classes of shares are entitled to be voted?**

A: Each common share and each 6 3/4% Cumulative Convertible Preferred Share outstanding as of the close of business on the Record Date is entitled to vote on all items being voted upon at the Annual Meeting. You are entitled to one vote for each common share and for each 6 3/4% Cumulative Convertible Preferred Share you own on the Record Date. The 6 3/4% Cumulative Convertible Preferred Shares will vote with the common shares as one class on the proposal described in this Proxy Statement. On the Record Date, we had 218,792,775 common shares and 155,250 6 3/4% Cumulative Convertible Preferred Shares issued and outstanding.

Q: **What is the quorum requirement for the meeting?**

A: The quorum requirement for holding the meeting and transacting business is a majority of the shares of common and preferred shares issued and outstanding and entitled to vote at such meeting. However, even if a quorum is present, if any particular action requires other than a simple majority under either the law, the Company s Amended Articles of Incorporation or the Company s Amended Regulations, that particular action will not be taken unless the required percentage of affirmative votes has been obtained.

Both abstentions and broker non-votes are counted as present for the purpose of determining the presence of a quorum. Abstentions are also counted as shares present and entitled to be voted. Broker non-votes, however, are not counted as shares present and entitled to be voted with respect to the matter on which the broker has expressly not voted. Thus, broker non-votes will not affect the outcome of any of the matters being voted upon at the meeting.

Q: **Who will count the votes?**

A: A representative of The Fifth Third Bank, Broadwing s transfer agent and registrar, will tabulate the votes and act as the inspector of election.

Q: **Is my vote confidential?**

A: Proxy instructions, ballots and voting tabulations that identify individual shareholders are handled in a manner that protects voting privacy. Your vote will not be disclosed either within Broadwing or to third parties except (1) as necessary to meet applicable legal requirements, (2) to allow for the tabulation of votes and certification of the vote, or (3) to facilitate a successful proxy solicitation by the Board. Occasionally, shareholders provide written comments on their proxy card, which are then forwarded to Broadwing s management.

Q: **Who will bear the cost of soliciting votes for the meeting?**

A: Broadwing is making this solicitation and will pay the entire cost of preparing, assembling, printing, mailing and distributing these proxy materials. If you choose to access the proxy materials and/or vote over the Internet, however, you are responsible for Internet access charges you may incur. In addition to the mailing of these proxy materials, the solicitation of proxies or votes may be made in person, by telephone or by electronic communication by our directors, officers and employees, who will not receive any additional compensation for such solicitation activities. We also have hired Georgeson Shareholder Communications Inc. to assist us in the distribution of proxy materials and the solicitation of votes. We will pay Georgeson Shareholder Communications Inc. a fee of $10,000 plus expenses for these services. We will also reimburse brokerage houses and other custodians, nominees and fiduciaries for their reasonable out-of-pocket expenses for forwarding proxy and solicitation materials to shareholders.

Q: **What percentage of the Company s issued and outstanding shares of voting stock do our directors and officers own?**

A: Our directors and officers owned approximately 2.10% of our voting stock as of the Record Date. See page 15 for more details.

Q: **Do any of our shareholders hold more than 5% of the issued and outstanding shares of any class of the Company s voting stock?**

A: As of February 22, 2002, various persons, entities and funds associated with Marc J. Gabelli and Mario J. Gabelli (collectively the Gabelli Entities) collectively owned 11,428,596 or 5.23%, of the issued and outstanding shares of common stock. As of December 31, 2001, Legg Mason, Inc., together with its subsidiaries, collectively owned 15,684,643, or 7.17%, of the issued and outstanding shares of common stock. See page 15 for more details.

Q: **What is householding?**

A: Householding is a process that allows the Company to reduce costs and increase efficiencies by mailing only one copy of Company communications, such as this Proxy Statement, to multiple shareholders who reside at the same household mailing address. If you and other shareholders at the same householding address are currently receiving only one copy of Company communications at your mailing address, but would like to receive separate copies, please see the instructions on page 30. If you and other shareholders at the same mailing address are currently receiving multiple copies of Company communications, but would like to participate in our Householding program, please see the instructions on page 30.

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BOARD STRUCTURE AND COMPENSATION

General Information

Our Board currently has 12 directors and the following four committees: (1) Audit and Finance, (2) Compensation, (3) Executive, and (4) Governance and Nominating. The members and function of each committee are described below. During fiscal year 2001, the Board held 7 meetings and no director attended less than 81% of all Board and applicable committee meetings.

Name of Director	Audit & Finance	Compensation	Executive	Governance & Nominating
Non-Employee Directors				
Lawrence J. Bouman	X			
Phillip R. Cox	X	X		
J. Taylor Crandall		X		
William A. Friedlander	X*		X	X
Karen M. Hoguet	X			
James D. Kiggen			X*	X*
Daniel J. Meyer		X		X
Mary D. Nelson	X			
Carl Redfield		X		
David B. Sharrock		X*		X
John M. Zrno				X
Employee Directors				
Richard G. Ellenberger			X	
Number of Meetings in Fiscal Year 2001	5	3	1	2

X = Committee member; * = Chair

Committees of the Board

Audit and Finance Committee: The Audit and Finance Committee consists of five persons, none of whom is an officer of the Company. The committee oversees the Company s financial reporting process, evaluates the adequacy of the Company s internal controls, reviews the Company s compliance with federal, state and local laws and regulations, and monitors the legal and ethical conduct of Company management and employees. In addition, the committee reviews the Company s financial affairs, including its capital structure, borrowing limits, financing of corporate acquisitions and the performance of its benefit plans.

Pursuant to Securities and Exchange Commission regulations, effective December 15, 2000, the audit committee of every company subject to the Securities Exchange Act of 1934 is required to have a written charter, which must be filed as an exhibit to its proxy statement once every three years. In 2000 the Board of Directors adopted a written charter for the Audit and Finance Committee and the Company attached the written charter as an exhibit to its 2000 proxy statement dated March 17, 2000.

Compensation Committee: The Compensation Committee consists of five persons, none of whom is an officer. The committee reviews the Company s executive compensation and employee benefit plans and programs, including their establishment, modification and administration.

Executive Committee: The Executive Committee consists of three persons, two of whom are officers. The committee acts on behalf of the Board in certain matters when necessary during the intervals between Board meetings.

Governance and Nominating Committee: The Governance and Nominating Committee consists of five persons, one of whom is an officer. The committee recommends nominees for the election of directors and officers, monitors the performance of the other Board committees, and informs the Board of shareholder

concerns. The Governance and Nominating Committee will also consider nominees from shareholders; see page 29 for details.

Director Compensation Arrangements

Compensation for Employee Directors

Directors who are also employees of the Company (or any subsidiary of the Company) receive no additional compensation for serving on the Board or its committees other than their normal salaries.

General Compensation Rules for Non-Employee Directors

Directors who are not employees of the Company or any subsidiary of the Company (non-employee directors) received a $16,000 annual retainer and $1,500 for each Board and committee meeting attended. Also, in 2001 the chairpersons of the Audit and Finance Committee and the Compensation Committee were paid an additional $3,000.

In lieu of the annual retainer and individual meeting fees, Mr. Kiggen, as Chairman of the Board, received for 2001 Company stock options equal in value to $300,000 on the date of grants, and supplemental medical insurance, the cost of which was approximately $1,200.

Effect of Directors Deferred Compensation Plan on Compensation of Non-Employee Directors

The Broadwing Inc. Deferred Compensation Plan for Outside Directors (the Directors Deferred Compensation Plan) allows each non-employee director of the Company to choose to defer receipt of all or a part of his or her director fees and annual retainers and to have such deferred amounts credited to an account of the director under the plan. Such account is also credited with assumed interest on such amounts, compounded quarterly at the end of each calendar quarter, at a rate equal to the average interest rate for ten-year United States Treasury notes for the previous quarter. A non-employee director is fully vested at all times in the amounts of the director fees and annual retainers that are credited to his or her account under the plan.

Each person who was a non-employee director of the Company on January 1, 2001 also had his or her account under the Directors Deferred Compensation Plan credited on such date with an amount equal to the value of 1,500 common shares. A non-employee director will be vested in the amounts credited to his or her account under the plan only if he or she completes at least five years of active service as a non-employee director of the Company (with a fraction of a year of service as a non-employee director being rounded up or down to the nearest whole year).

Except as is noted below, in the event of a change in control of the Company, when a non-employee director of the Company terminates his or her position as such a director, the vested amounts then credited to his or her account under the Directors Deferred Compensation Plan (including certain amounts credited prior to 1998 or attributable to pre-1998 credits) are paid to him or her (or, in the case of his or her death, to a beneficiary of such non-employee director) in a lump sum payment of stock or in annual installments of stock (up to ten such installments), as the director may elect under the provisions of the plan. However, if a change in control of the Company (as such term is defined in the Directors Deferred Compensation Plan) occurs prior to the non-employee director terminating his or her position as a director of the Company, the amounts credited to his or her account are generally fully vested without regard to the forfeiture provisions noted in the preceding paragraph of this discussion or otherwise provided in the plan, and such amounts are generally paid to the non-employee director in one lump sum payment of stock as of the day next following the date on which the change in control occurs.

Until paid, all amounts credited to a non-employee director s account under the Directors Deferred Compensation Plan are not funded or otherwise secured, and all payments under the plan are made from the general assets of the Company and its subsidiaries.

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Effect of Directors Stock Option Plan on Compensation of Non-Employee Directors

The Company grants its non-employee directors stock options to purchase common shares under the Broadwing Inc. 1997 Stock Option Plan for Non-Employee Directors (The 1997 Stock Option Plan for Non-Employee Directors, together with certain predecessor non-employee director stock option plans of the Company, the Directors Stock Option Plan). Pursuant to the current terms of such plan, each non-employee director is granted:

- a stock option for 25,000 common shares on the first day of his or her term of office as a director and
- a stock option for 9,000 common shares on the date of each annual meeting, if such director first became a non-employee director before the date of such annual meeting and continues in office as a non-employee director after such meeting.

Each stock option granted a non-employee director under the Directors Stock Option Plan requires that the price to be paid upon the exercise of such option for the Common Shares that are subject to the option will equal 100% of the fair market value of such shares (as determined at the time the option is granted).

Other Compensation for Non-Employee Directors

The Company also provides its non-employee directors with certain telecommunications services. The average annual cost of such services was approximately $344 per non-employee director in 2001.

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ELECTION OF DIRECTORS

(Item 1 on the Proxy Card)

The Board of the Company presently consists of twelve members, two of whom are officers of the Company. The Company s Amended Articles of Incorporation provide for the directors to be divided into three classes. At each annual meeting of shareholders, directors constituting a class are elected for three-year terms. The terms of the four directors in Class III expire in 2002. The terms of the four directors in Class I expire in 2003. The terms of the four directors in Class II expire in 2004. The directors of each class will serve until their respective successors are elected and qualified.

The Board has nominated J. Taylor Crandall, Daniel J. Meyer and Mary D. Nelson, all of whom are incumbent directors, as Class III directors, to serve until the 2005 annual meeting of shareholders. Information regarding the business experience of each nominee is provided below.

James D. Kiggen will retire as Chairman of the Board and as an officer and Director, effective at the close of the 2002 Annual Meeting. On January 25, 2002, the Board passed a resolution setting the size of the Board at eleven members following Mr. Kiggen s retirement. Mr. Ellenberger will become Chairman of the Board at the organizational meeting immediately following the 2002 Annual Shareholder Meeting.

Pursuant to an Investment Agreement dated July 21, 1999 between the Company and Oak Hill Capital Management, Inc., as long as Oak Hill and its affiliated entities hold at least two-thirds of the common shares issued or issuable upon conversion of $400,000,000 of convertible subordinated debentures of the Company, Oak Hill has the right to designate one director. Mr. J. Taylor Crandall is currently the designee of Oak Hill and is serving as a Class III director.

The shares represented by the accompanying proxy or voting instruction card will be voted FOR the election of the Class III director nominees, unless contrary instructions are indicated as provided on the proxy or voting instruction card. (If you do not wish your shares to be voted for particular nominees, please so indicate on the proxy or voting instruction card, or if voting over the Internet or telephone follow the voting instructions provided to you.) If one or more of the nominees should at the time of the meeting be unavailable or unable to serve as a candidate, the shares represented by the proxies will be voted to elect the remaining nominees and any substitute nominee or nominees designated by the Board. The Board knows of no reason why any of the nominees will be unavailable or unable to serve.

Our Recommendation

The three director nominees who receive the greatest number of votes will be elected to the Board of Directors. Votes against a candidate, abstentions and broker non-votes will have no legal effect. The Board recommends election of each of the nominees.

For each director of the Company, including those nominated for election, there follows a brief listing of principal occupation during at least the past five years, other major affiliations and age on the date of this Proxy Statement.

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NOMINEES FOR CLASS III DIRECTORS

(Terms Expire in 2005)

J. Taylor Crandall	Mr. Crandall is Managing Partner of Oak Hill Capital Management, Inc. and Chief Operating Officer of Keystone, Inc. He is a director of the American Skiing Company, Sunterra Corporation, U.S. Oncology Inc., Meristar Hospitality Corporation, Meristar Hotels & Resorts, Inc. and Washington Mutual, Inc. He serves on the Board of Advisors of Oak Hill Capital Partners and Oak Hill Strategic Partners, L.P. He is a member of Investment Committees of Insurance Partners, L.P. and Brazos Fund, L.P.; and a member of the Advisory Committees of Boston Ventures Limited Partnership V and B-K Capital Partners, L.P. Director since 1999. Age 48.
Daniel J. Meyer	Mr. Meyer is retired. He served as Chairman and Chief Executive Officer of Milacron, Inc. (a manufacturer of metal working and plastics processing machinery and systems) from 1999-2001. He served as President of Milacron, Inc. from 1998-1999; as its Chairman since 1991; and as its Chief Executive Officer since 1990. He is a director of The E.W. Scripps Company, Milacron, Inc., AK Steel Holding Corporation and Hubbell Incorporated. Director since 1999. Age 65.
Mary D. Nelson	Mrs. Nelson is retired. She served as President of Nelson & Co. (consulting actuaries) from 1975-1999. She served as a director of Blount International, Inc. and its subsidiary, Blount Inc., from 1986-1999 and is currently a director of The Union Central Life Insurance Company. Director since 1994. Age 68.

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CLASS I DIRECTORS

(Terms Expire in 2003)

Richard G. Ellenberger	Mr. Ellenberger has been President and Chief Executive Officer of the Company since March 1, 1999; Chief Operating Officer of the Company since July 1, 1998; President and Chief Executive Officer of Cincinnati Bell Telephone Company from 1997-1998; and Chief Executive Officer of Broadwing Communications Inc. since November 9, 1999. He served as Chief Executive Officer of XLConnect from 1996-1997. He served as President, Business Services of MCI Telecommunications, from 1995-1996; Senior Vice President, Worldwide Sales of MCI Telecommunications, 1994-1995; Senior Vice President, Branch Operations of MCI Telecommunications, 1993-1994; and Vice President, Southeast Region of MCI Telecommunications, 1992-1993. Mr. Ellenberger will become Chairman of the Board at the organizational meeting following the close of the 2002 Annual Meeting. Director since 1998. Age 49.
Karen M. Hoguet	Ms. Hoguet is Chief Financial Officer and Senior Vice President of Federated Department Stores, Inc. (owner and operator of retail department stores). At Federated Department Stores, she has served as a Senior Vice President since 1991; as Treasurer from 1992-1999; and as Chief Financial Officer since 1997. Director since 1999. Age 45.
Carl Redfield	Mr. Redfield has been Senior Vice President of Worldwide Manufacturing/Logistics at Cisco Systems, Inc. since 1999; Vice President, Manufacturing/Logistics of Cisco Systems, Inc., from 1993-1999. Before that, he served as Senior Director, Manufacturing/Logistics Personal Computer Division, Digital Equipment Corporation, from 1975-1993. He is a director of CTC Communications Group, Inc., iBasis, Inc., and VA Software Corporation. Director since 2000. Age 55.
David B. Sharrock	Mr. Sharrock has been a consultant since 1994. Prior to that, he served as Executive Vice President and Chief Operating Officer of Marion Merrell Dow Inc. (a researcher, manufacturer and seller of pharmaceutical products) from 1989-1993. He served as President and Chief Operating Officer of Merrell Dow Pharmaceuticals Inc. from 1988-1989. He is a director of Interneuron Pharmaceuticals Inc., Incara Pharmaceuticals, Inc., Praecis Pharmaceuticals, Inc., and MGI Pharma, Inc. Director since 1987. Age 65.

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CLASS II DIRECTORS

(Terms Expire in 2004)

Lawrence J. Bouman	Mr. Bouman has been a consultant since 1999. Prior to that, he served as Executive Vice President-Product Development of Qwest Communications International, Inc. from 1998-1999. He served as Chief Technology Officer of LCI International, Inc. from 1995-1998. He is a director of Metasolv Software Inc. Director since 2001. Age 55.
Phillip R. Cox	Mr. Cox has been President and Chief Executive Officer of Cox Financial Corporation (a financial planning services company) since 1972. He is a director of Federal Reserve Bank of Cleveland, Cinergy Corp., Touchstone Mutual Funds, PNC Bank, Ohio, N.A., and Long Stanton Manufacturing Company. Director since 1993. Age 55.
William A. Friedlander	Mr. Friedlander has been Chairman of Bartlett & Co. (a registered investment advisor) since 1989; he was Bartlett & Co. s Chief Executive Officer from 1966-1989. He is a director of The Union Central Life Insurance Company and Center Bank. Director since 1986. Age 69.
John M. Zrno	Mr. Zrno is retired. He was President and Chief Executive Officer of IXC Communications, Inc. from June 1999-November 1999. He served as President and Chief Executive Officer of ALC Communications Corporation from 1988-1995. Director since 1999. Age 63.

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Any general statement that incorporates this Proxy Statement into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934 shall not be deemed to incorporate by reference this Audit and Finance Committee Report and related disclosure. Except to the extent the Company specifically incorporates such Report and related disclosure by reference, this information shall not otherwise be deemed to have been filed under such Acts.

AUDIT AND FINANCE COMMITTEE REPORT

The Audit and Finance Committee of the Board has reviewed and discussed the Company s audited financial statements with the management of the Company, and has obtained a report from management assessing the Company s internal controls. The Audit and Finance Committee has discussed with PricewaterhouseCoopers LLP, the Company s independent accountants, the matters required by SAS 61 (Codification of Statements on Auditing Standards, AU § 380) to be discussed. The Audit and Finance Committee has also received the written disclosures and letter from the independent accountants required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), has discussed with PricewaterhouseCoopers LLP the independence of such independent accounting firm and has considered the question of whether the auditors provision of non-audit services was compatible with the auditors maintaining their independence.

Based on its review and discussions referred to in the preceding paragraph, the Audit and Finance Committee recommended to the Board that the audited financial statements for the Company s fiscal year ended December 31, 2001 be included in the Company s Annual Report on Form 10-K for the Company s fiscal year ended December 31, 2001.

Each of the members of the Audit and Finance Committee is independent within the meaning of Sections 303.01(B)(2)(a) and (3) of the listing standards of the New York Stock Exchange.

AUDIT AND FINANCE COMMITTEE:

William A. Friedlander, Chairman
Lawrence J. Bouman
Phillip R. Cox
Karen M. Hoguet
Mary D. Nelson

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INDEPENDENT PUBLIC ACCOUNTANTS

For the fiscal year 2002, the Board has selected PricewaterhouseCoopers LLP as its principal outside accountant.

Representatives of PricewaterhouseCoopers LLP are expected to be present at the Annual Meeting, will have the opportunity to make a statement if they desire to do so, and are expected to be available to respond to appropriate questions.

AUDIT FEES

The Company s independent accountants, PricewaterhouseCoopers LLP, disclosed that for services rendered by PricewaterhouseCoopers LLP to Broadwing in 2001 they have billed the following fees and expenses:

Audit Fees for the Calendar Year 2001 Audit and review of annual and quarterly financial statements ($517,000 billed through December 31, 2001)	$ 701,500
Financial Information Systems Design and Implementation Fees	$ 0
Tax Compliance and Consulting	$ 258,301
Accounting and Regulatory Related Support	$ 500,750
All Other Fees	$ 399,000
Total	$1,799,551

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STOCK OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth the beneficial ownership of common shares and 6 3/4% Cumulative Convertible Preferred Shares as of March 5, 2002 by (i) each beneficial owner of more than five percent (5%) of either class of stock, (ii) each director and each executive officer named in the Summary Compensation Table on page 19, and (iii) all directors and executive officers of the Company as a group.

Unless otherwise indicated, the address of each director and executive officer is care of Broadwing at Broadwing s address.

Name and Address of Beneficial Owner	Title of Class	Shares Beneficially Owned as of Mar. 5, 2002 (unless otherwise noted)	Percent of Common Shares	Percent of 6 3/4% Cumulative Convertible Preferred Shares
Legg Mason, Inc.(a) 100 Light Street Baltimore, MD 21202	Common	15,688,643(b)	7.17(b)	
various Gabelli Entities(c) c/o Gabelli Asset Management Inc. One Corporate Center Rye, NY 10580-1435	Common	11,428,596(d)	5.32(d)	
Lawrence J. Bouman(e)	Common	30,300	.01	
Michael J. Callaghan	Common	94,326	.04	
John F. Cassidy(e)	Common	410,464	.19	
Phillip R. Cox(e)	Common	64,936	.03	
J. Taylor Crandall(e)	Common	43,000	.02	
Richard G. Ellenberger(e)	Common	1,043,970	.48	
William A. Friedlander(e)(f)(g)	Common	340,949	.16	
Karen M. Hoguet(e)	Common	57,325	.03	
James D. Kiggen(e)(f)	Common	174,145	.08	
Daniel J. Meyer(e)	Common	44,000	.02	
Kevin W. Mooney(e)	Common	287,597	.13	
Mary D. Nelson(e)	Common	67,250	.03	
Richard S. Pontin(e)(h)	Common	295,810	.14	
Carl Redfield(e)	Common	34,000	.02	
David B. Sharrock(e)	Common	61,052	.03	
Jeffrey C. Smith(e)(f)	Common	396,995	.18	
John M. Zrno(e)	Common	1,026,690	.47	
All directors and officers as a group (consisting of 19 persons, including those named above)	Common	4,601,197	2.10	

(a) As reported in the Form 13(G) filed on February 14, 2002 by Legg Mason, Legg Mason, Inc. is the parent holding company for, and shares voting and investment power for these shares with, its investment advisory subsidiaries Legg Mason Funds Management, Inc., LMM LLC, Bartlett & Co., Bingham Legg Advisers LLC, Legg Mason Capitol Management, Inc., and Legg Mason Wood Walker, Inc. (investment advisor and broker/dealer with discretion). Shares may be placed in accounts which are managed by various investment advisory subsidiaries; no such account owns more than 5% of the shares outstanding.

(b) Share amounts are identified through December 31, 2001, as reported on Form 13(G) filed on February 14, 2002, by Legg Mason, Inc.

(c) As reported in the Form 13(D) filed on March 4, 2002 by Gabelli Asset Management Inc. on behalf of the Gabelli entities, ownership of the common shares is by the following Gabelli Entities or persons: Gabelli Funds, LLC; GAMCO Investors, Inc.; Gabelli International Limited; Gabelli Performance Partnership, L.P.; Gabelli & Company, Inc. Profit Sharing Plan; Gemini Capital Management, LLC; MJG Associates, Inc.; Gabelli Securities, Inc.; Gabelli Group Capital Partners, Inc.; Gabelli Asset Management Inc.; Marc J. Gabelli; and Mario J. Gabelli. Ownership amounts for the respective Gabelli Entities are identified in the Form 13(D). Voting and investment powers for the shares are retained by the respective identified owner and are not shared with other Gabelli Entities or persons.

(d) Share amounts are identified through February 22, 2002, as reported on Form 13(D) filed on March 4, 2002, by Gabelli Asset Management, Inc.

(e) Includes common shares subject to outstanding options under the Broadwing Inc. 1997 Long Term Incentive Plan and the Directors Stock Option Plan which are exercisable by such individuals within 60 days. The following options are included in the totals: 30,300 common shares for Mr. Bouman; 351,700 common shares for Mr. Cassidy; 61,875 common shares for Mr. Cox; 46,250 common shares for Mr. Friedlander; 98,700 common shares for Mr. Kiggen; 42,250 common shares for Mrs. Nelson; 53,625 common shares for Mrs. Hoguet; 54,250 common shares for Mr. Sharrock; 868,250 common shares for Mr. Ellenberger; 43,000 common shares for each of Messrs. Crandall and Meyer; 212,700 common shares for Mr. Mooney; 236,800 common shares for Mr. Pontin; 34,000 common shares for Mr. Redfield; 366,647 common shares for Mr. Smith; and 1,021,690 common shares for Mr. Zrno.

(f) Includes common shares held directly by the director or officer or by a person with whom the director or officer has a duty of trust or confidence such as a spouse, parents, children or sibling, but as to which common shares the director or officer disclaims beneficial ownership: 10,000 for Mr. Friedlander; 3,626 for Mr. Kiggen; 4,400 for Mr. Smith and 3,010 for all others. Each of the above expressly declares that the filing of this Proxy Statement shall not be construed as an admission that such person is beneficial owner, for purposes of Section 13(d) or 13(g) of the Securities Exchange Act of 1934.

(g) Includes 163,500 common shares as to which Mr. Friedlander disclaims beneficial ownership. Mr. Friedlander has sole investment power as to these 163,500 common shares. Does not include shares owned by Legg Mason, Inc. or its subsidiary Bartlett Advisors, Inc., for which Mr. Friedlander disclaims beneficial ownership. Mr. Friedlander expressly declares that the filing of this Proxy Statement shall not be construed as an admission that he is beneficial owner, for purposes of Section 13(d) or 13(g) of the Securities Exchange Act of 1934.

(h) Mr. Pontin separated from employment with the Company in November, 2001.

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EXECUTIVE COMPENSATION

Any general statement that incorporates this Proxy Statement into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934 shall not be deemed to incorporate by reference this Compensation Committee Report on Executive Compensation and related disclosure. Except to the extent the Company specifically incorporates such Report and related disclosure by reference, this information shall not otherwise be deemed to have been filed under such Acts.

Compensation Committee Report on Executive Compensation

The Compensation Committee of the Board of Directors administers Broadwing s executive compensation program. The Compensation Committee, which is composed of non-employee directors, is responsible for approving and reporting to the Board on all elements of compensation for the Company s Chief Executive Officer (CEO) and other executive officers. The Compensation Committee has furnished the following report on executive compensation for fiscal year 2001.

Compensation Philosophy

The principles of the executive compensation program established by the Compensation Committee are that:

Compensation must be competitive with other companies to attract and retain high-quality executives;

A significant portion of executive compensation should be at risk and tied to the achievement of specific short-term and long-term performance objectives, principally the Company s earnings and the performance of the Company s common shares, thereby linking executive compensation with the returns realized by shareholders; and

Emphasis should be given to the long-term incentive component of each executive s compensation package, rather than to base salary or annual incentives.

Executive Compensation Practices

The Compensation Committee targets each executive officer s total direct compensation (base salary, annual incentive compensation and long-term incentive compensation) to be competitive with the median of the marketplace, adjusted for revenue size, using information from general industry, telecommunications and high-technology surveys conducted by outside consultants.

Components of Executive Compensation

The Company s executive compensation program for executive officers consists of three components: base salary, annual incentive compensation and long term incentive compensation.

Base Salary. Based on its review of the market data, the Compensation Committee recommended base salary increases for the named executive officers in the Summary Compensation Table set forth on page 19 to ensure equity with the market, reflect the assumption of increased responsibilities and, where appropriate, reflect an analysis of each executive officer s individual performance. The salaries of Messrs. Ellenberger, Mooney, Cassidy, Pontin and Smith appear in the Summary Compensation Table on page 19.

Annual Incentive. The Company s Short-Term Incentive Plan, in which all of the above-named executives participated, was one of the means by which the Compensation Committee encouraged the Company s management to enhance shareholder value. As in the case of base salary, short-term award targets under this plan for 2001 were benchmarked against market data. For Messrs. Ellenberger, Mooney, Callaghan and Smith to have received a short-term award, the Company must have achieved certain levels of earnings before interest, taxes, depreciation & amortization (EBITDA) and revenue. For Mr. Cassidy to have received a short-term award, Cincinnati Bell must have achieved certain levels of EBIDTA and revenue. In addition, a portion of each executive officer s short-term award was based on individual performance. Short-term awards are paid in cash.

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Long-Term Incentives. The Company s executive compensation program currently includes stock options under the Company s Long-Term Incentive Plan (LTIP), restricted stock, and performance unit awards. Long-term incentives are intended to more closely align the interests of the Company s executive officers with those of the Company s shareholders. Stock options under the LTIP are awarded at the discretion of the Compensation Committee.

In the past, the present value of the stock options awarded to Mr. Ellenbate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. STOCK-BASED COMPENSATION On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company's financial statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). There was no stock-based compensation expense related to employee or director stock options recognized during the years ended December 31, 2005 or 2004. Options issued to consultants are accounted for in accordance with the provisions of Emerging Issues Task Force (EITF) No. 96-18, "Accounting for Equity Instruments That Are Issued to Others Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." 31 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS As a result of adopting SFAS 123(R) on January 1, 2006, the Company's income before income taxes and net income for the year ended December 31, 2006 are $395,000 lower than if it had continued to account for share-based compensation under APB Opinion 25. The following table illustrates the effect on net income and loss per share if the Company had applied the fair value recognition provisions of SFAS 123(R) to stock-based awards granted under the Company's stock option plans in all periods presented. For purposes of this pro-forma disclosure, the fair value of the options is estimated using the Black-Scholes-Merton option-pricing formula ("Black-Scholes model") and amortized to expense generally over the options' vesting periods. 2005 2004 ------------ ------------ Net loss as reported .... $(29,537,709) $(17,608,968) Add: Stock-based employee compensation expense included in reported net income, net of related tax effects .... -- -- Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects .... (221,167) (55,228) ------------ ------------ Pro forma net loss .... $(29,758,876) $(17,664,196) ============ ============ Loss per share: Basic - as reported .... $ (1.62) $ (1.02) Basic - pro forma .... $ (1.63) $ (1.02) SFAS 123(R) requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statements of Operations. Stock-based compensation expense recognized in the Statements of Operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with how the prior-period pro formas were provided. As stock-based compensation expense recognized in the Statements of Operations for 2006 is based on awards expected to vest, SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the year ended December 31, 2006, expected forfeitures are immaterial and as such the Company is recognizing forfeitures as they occur. In the pro-forma information provided under SFAS 123 for the periods prior to 2006, the Company accounted for forfeitures as they occurred. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB Opinion 25. Under the intrinsic value method, the Company recognized share-based compensation equal to the award's intrinsic value at the time of grant over the requisite service periods using the straight-line method. Forfeitures were recognized as incurred. During the years ended December, 31, 32 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS 2005 and 2004, there was no stock-based compensation expense recognized in the Statements of Operations for awards issued to employees and directors as the awards had no intrinsic value at the time of grant because their exercise prices equaled the fair values of the common stock at the time of grant. The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards, and actual and projected employee stock option exercise behaviors. The Company estimates expected volatility using historical data. The expected option term is estimated using the "safe harbor" provisions under SAB 107. The Company has elected to adopt the detailed method provided in SFAS 123(R) for calculating the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). COMPREHENSIVE INCOME The Company has adopted Statement of Financial Standard No. 130, "Reporting Comprehensive Income" ("SFAS 130"), issued by the FASB and effective for financial statements with fiscal years beginning after December 15, 1997. SFAS 130 establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. There were no material other comprehensive income items for the years ended December 31, 2006, 2005 and 2004. REVENUE RECOGNITION Sales are recognized when persuasive evidence of an arrangement exists, product delivery has occurred, pricing is fixed or determinable, and collection is reasonably assured. Sales resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns, and the cost of products sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances. Sales rebates and discounts are common practice in the industries in which the Company operates. Volume, promotional, price, cash and other discounts and customer incentives are accounted for as a reduction to gross sales. Rebates and discounts are recorded based upon estimates at the time products are sold. These estimates are based upon historical experience for similar programs and products. The Company reviews such rebates and discounts on an ongoing basis and accruals for rebates and discounts are adjusted, if necessary, as additional information becomes available. RECLASSIFICATION Certain reclassifications have been made to the prior year financial statements to conform to 2006 presentation in this annual report . The amortization of deferred financing costs and discounts are reported as "Interest Expense, net" on the consolidated statement of operations. These items ($310,771 and $45,000 for 2005 and 2004, respectively) were previously reported as "General and Administrative Expenses". The Consolidated Statement of Cash Flows for 2004 reflects a decrease in inventory valuation reserves of $240,000 in the Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities. This amount was previously reported net, in the Changes in operating assets and liabilities- Inventory. In 2006 Cash flows from operating activities include Note receivable collections of $640,539 and Repayments of notes payable converted from accounts payable of $867,297. These items were reported as Cash flows from financing activities in prior versions of this annual report filed on Form 10-KA. 33 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CLASSIFICATION OF EXPENSES COST OF SALES - Cost of goods sold primarily includes expenses related to inventory purchases, customs, duty, freight, overhead expenses and reserves for obsolete inventory. Overhead expenses primarily consist of warehouse and operations salaries, and other warehouse expenses. SELLING EXPENSE - Selling expenses primarily include royalty expense, sales salaries and commissions, travel and entertainment, marketing and other sales-related costs. GENERAL AND ADMINISTRATIVE EXPENSES - General and administrative expenses primarily include administrative salaries, employee benefits, professional service fees, facility expenses, information technology costs, investor relations, travel and entertainment, depreciation and amortization, bad debts, restructuring costs and other general corporate expenses. INTEREST EXPENSE AND INTEREST INCOME - Interest expense reflects the cost of borrowing and amortization of deferred financing costs and discounts. Interest expense for the years ended December 31, 2006, 2005 and 2004 was $1,357,000, $1,446,000, and $882,000, respectively. Interest income of $368,000, $66,000 and $32,000 for the years ended December 31, 2006, 2005 and 2004, respectively, consists of earnings from outstanding amounts due to the Company under notes and other interest bearing receivables. SHIPPING AND HANDLING COSTS In accordance with Emerging Issues Task Force (EITF) 00-10, Accounting for Shipping and Handling Fees and Costs, the Company records shipping and handling costs billed to customers as a component of revenue, and shipping and handling costs incurred by the Company for outbound freight are recorded as a component of cost of sales. Total shipping and handling costs included as component of revenue for the years ended December 31, 2006, 2005 and 2004 amounted to $146,000, $98,000 and $194,000. Total shipping and handling costs included as a component of cost of sales for each of these years amounted to $691,000, $925,000 and $1,002,000. RESTRUCTURING CHARGES The Company records restructuring reserves in compliance with SFAS 146 "Accounting for Costs Associated with Exit or Disposal Activities", resulting in the recognition of employee severance and related termination benefits for recurring arrangements as they are incurred and on the accrual basis for one-time benefit arrangements. The Company records other costs associated with exit activities as they are incurred. Employee severance and termination benefits are estimates based on agreements with the relevant union representatives or plans adopted by the Company that are applicable to employees not affiliated with unions. These costs are not associated with nor do they benefit continuing activities. Inherent in the estimation of these costs are assessments related to the most likely expected outcome of the significant actions to accomplish the restructuring. Changing business conditions may affect the assumptions related to the timing and extent of facility closure activities. The Company reviews the status of restructuring activities on a quarterly basis and, if appropriate, records changes based on updated estimates. See Note 11, "2005 Restructuring Plan". LITIGATION We are currently involved in various lawsuits, claims and inquiries, most of which are routine to the nature of the business, and in accordance with SFAS No. 5, "Accounting for Contingencies," we accrue estimates of the probable and estimable losses for the resolution of these claims. The ultimate resolution of these claims could affect our future results of operations for any particular quarterly or annual period should 34 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued. FAIR VALUE OF FINANCIAL INFORMATION The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value. Accounts receivable: Due to the short-term nature of the receivables, the fair value approximates the carrying value. Due from related parties and notes payable to related parties: Due to the short-term nature and current market borrowing rates of the loans and notes, the fair value approximates the carrying value. Notes payable: Fair value approximates carrying value based upon current market borrowing rates for loans with similar terms and maturities. NEW ACCOUNTING PRONOUNCEMENTS In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements", ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, and does not require any new fair value measurements. The application of SFAS No. 157, however, may change current practice within an organization. SFAS No. 157 is effective for all fiscal years beginning after November 15, 2007, with earlier application encouraged. The Company does not believe that SFAS No. 157 will have a material impact on the Company's financial position, results of operations or cash flows. In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires the quantification of misstatements based on their impact on both the balance sheet and the income statement to determine materiality. The guidance provides for a one-time cumulative effect adjustment to correct for misstatements that were not deemed material under a company's prior approach but are material under the SAB 108 approach. SAB 108 is effective for fiscal years ending after November 15, 2006. The implementation of SAB 108 did not have a material impact on the financial position, results of operations or cash flows of the Company. In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes -- An Interpretation of FASB Statement No. 109, (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect that the application of FIN 48 will have on its results of operations and financial condition. In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments" ("SFAS 155"), which amends SFAS No. 133, "Accounting for Derivatives Instruments and Hedging Activities" ("SFAS 133") and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" ("SFAS 140). SFAS 155 amends SFAS 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS 155 also amends SFAS 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is 35 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS a derivative instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe that SFAS No. 155 will have a material impact on the Company's financial position, results of operations or cash flows. NOTE 2 - ACCOUNTS AND NOTE RECEIVABLE At December 31, 2006 a note receivable from Azteca Productions International ("Azteca") was outstanding in the amount of $2,799,460. The note is receivable in monthly installments over thirty-one months beginning March 1, 2006. The payments are $50,000 per month for the first 5 months, then range from $133,000-$267,000 per month until paid in full. At December 31, 2005, accounts receivable from Azteca, a significant customer in 2005, was approximately $10,968,000 less a reserve of $7,528,000. In February 2006, the Company accepted a note agreement from Azteca which provided for total payments including principal and interest of $4.0 million in exchange for the net outstanding accounts receivable balance. The value of the note receivable recorded effective at December 31, 2005 reflected a $560,000 charge to the face value to discount the note, using a 10.5% discount rate, to its net present value. The Azteca accounts receivable, net at December 31, 2005 was reclassified on the accompanying consolidated balance sheets to note receivable to reflect this subsequent settlement. The following summarizes the future minimum payments of the note receivable: Years ending December 31, Amount ----------- 2007 .... $ 1,599,996 2008 .... 1,483,339 ----------- Total payments .... 3,083,335 Less amount representing interest .... (283,875) ----------- Balance at December 31, 2006 .... 2,799,460 Less current portion .... 1,378,491 ----------- Long-term portion .... $ 1,420,969 =========== Accounts receivable are included on the accompanying consolidated balance sheet net of an allowance for doubtful accounts. The total allowance for doubtful accounts at December 31, 2006 was $71,500. The total allowance for doubtful accounts at December 31, 2005 was $1,188,758, after reclassification of the net Azteca receivable to note receivable. In 2004, following negotiations with Tarrant Apparel Group, a former customer, we determined that a significant portion of the obligations due from this customer were uncollectible. Accordingly, included in general and administrative expenses for 2004 are charges of $4.3 million related primarily to the write-down of this receivable and leaving a remaining balance receivable from this customer of $4.5 million. An affiliate of the customer repaid the $4.5 million receivable balance over the period from May through December 2005. NOTE 3 - FACTORING AGREEMENT The Company entered into a factoring agreement with East Asia Heller in 2004 for the purchase of eligible receivables from its Hong Kong subsidiary, Tag-It Pacific (HK) Limited. The factor may purchase eligible accounts receivable and assume the credit risk with respect to those accounts for which they have given their prior approval. If the factor does not assume the credit risk for a receivable, the collection risk associated with the receivable remains with the Company. The Company pays a fixed commission rate and 36 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS may borrow up to 80% of its eligible accounts receivable. Interest is charged at 1.5% over the Hong Kong Dollar prime rate (7.75% and 7.75% at December 31, 2006 and 2005). However, during 2005 and 2006 the factor declined to advance funds to the Company under this agreement. Accordingly, as of December 31, 2006, and 2005 there were no outstanding advances from the factor. NOTE 4 - DEMAND NOTES PAYABLE TO RELATED PARTIES Demand notes payable to related parties consist of the following: Year Ended December 31, ------------------------------- 2006 2005 -------------- -------------- Two notes payable issued from 1995-1998 to parties related to or affiliated with directors of the Company with interest rates ranging from 0% to 10% per annum, due and payable on the fifteenth day following delivery of written demand for payment ...... $ 85,176 $ 85,176 Convertible secured note payable issued in October 2000 to a director of the Company bears interest at 11%, payable quarterly, is due on demand and convertible into common stock at the election of the holder at a rate of $4.50 per share, the market value of the Company's common stock on the date of approval by the Company's Board of Directors. The note is secured by substantially all of the Company's assets ... 500,000 500,000 Unsecured notes payable to a director of the Company accrue interest at 7% and 8.5% per annum, principal and interest due on demand and fifteen days from demand .... 79,795 79,795 -------------- -------------- $ 664,971 $ 664,971 ============== ============== Interest expense related to the demand notes payable to related parties for the years ended December 31, 2006, 2005 and 2004 amounted to $67,753, $67,753, and $81,628. Included in accrued expenses at December 31, 2006 and 2005 was $515,738 and $447,986 of related accrued interest. There was no interest paid on the demand notes during the years ended December 31, 2006 and 2005. 37 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 5 - CAPITAL LEASE OBLIGATIONS The Company financed equipment purchases through various capital lease obligations expiring through August 2010. These obligations bear interest at various rates ranging from 4.6% to 15% per annum. Future minimum annual payments under these capital lease obligations are as follows: Years ending December 31, Amount ----------------------- ----------- 2007 .... $ 505,029 2008 .... 336,970 2009 .... 184,606 2010 .... 430 ----------- Total payments .... 1,027,035 Less amount representing interest .... (119,574) ----------- Balance at December 31, 2006 .... 907,461 Less current portion .... 432,728 ----------- Long-term portion

.... $ 474,733 =========== At December 31, 2006, total property and equipment under capital lease obligations and related accumulated depreciation was $3,533,154 and $1,178,469, respectively. At December 31, 2005, total property and equipment under capital lease obligations and related accumulated depreciation was $3,468,721 and $661,533, respectively. NOTE 6 - NOTES PAYABLE Notes payable consist of the following: Year Ended December 31, ------------------------------ 2006 2005 -------------- -------------- $765,000 note payable to First National Bank dated June 3, 2004; interest at 6.5%; payable in eighty-four monthly payments of principal and interest of $5,746 beginning July 2004; twenty-year amortization, all unpaid principal and interest due June 3, 2011 (seven years); secured by building in North Carolina .... $ 712,950 $ 734,787 $880,000 note payable to First National Bank dated November 22, 2004; interest at 6.5%; payable in sixty monthly payments of principal and interest of $17,254 beginning December 2004; all unpaid principal and interest due November 22, 2009; secured by manufacturing equipment .... 548,068 713,068 $1,650,000 note payable to Hennigan, Bennett & Dorman, LLP dated May 31, 2006; interest at 3.0%; payable in fourteen monthly payments of principal and interest beginning June 2006, of $50,000 for the first two payments, and $133,333 for the next twelve months thereafter until July 1, 2007; secured by the note receivable .... 907,703 -- -------------- -------------- Notes Payable .... 2,168,721 1,447,855 Less Current portion .... 1,107,207 186,837 -------------- -------------- Notes payable, net of current portion $ 1,061,514 $ 1,261,018 ============== ============== 38 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Future minimum annual payments under these notes payable obligations are as follows: Years ending December 31, Amount ----------------------- ---------- 2007 .... $1,107,207 2008 .... 213,030 2009 .... 210,218 2010 .... 28,301 2011 and thereafter .... 609,965 ---------- Total .... $2,168,721 ========== NOTE 7 - SECURED CONVERTIBLE PROMISSORY NOTES On November 10, 2004, the Company raised $12.5 million from the sale of Secured Convertible Promissory Notes (the "Notes") to existing shareholders. The Notes are convertible into common stock at a price of $3.65 per share, bear interest at 6% payable quarterly, are due November 9, 2007 and are secured by the Talon trademarks. The Notes are convertible at the option of the holder at any time after closing. The Company may repay the Notes at any time after one year from the closing date with a 15% prepayment penalty. Among other restrictions, the Notes restrict the Company from declaring or paying a dividend prior to conversion or payment of the Notes. At maturity, the Company may repay the Notes in cash or require conversion if certain conditions are met. In connection with the issuance of the Notes, the Company issued to the Note holders, warrants to purchase up to 171,235 shares of common stock. The warrants have a term of five years, an exercise price of $3.65 per share and vested 30 days after closing. The fair value of the warrants was estimated at approximately $96,000 utilizing the Black-Scholes model and recorded as a discount against the face value of the Notes. The discount is amortized over the three-year term of the Notes on a straight-line basis. The Company has registered the resale by the holders of the shares issuable upon conversion of the Notes and exercise of the warrants. In connection with this financing, the Company paid the placement agent $704,000 in cash, and issued the placement agent a warrant to purchase 215,754 common shares at an exercise price of $3.65 per share. The warrant is exercisable beginning May 10, 2005 through November 10, 2009. The fair value of the warrant was estimated at $93,815 utilizing the Black-Scholes model and recorded as deferred financing costs which are amortized over the three- year term of the Notes. The full amount of principal under these secured convertible promissory notes is due November 7, 2007. (See Item 7. Management's Discussion and Analysis). NOTE 8 - STOCKHOLDERS' EQUITY AND CONVERTIBLE REDEEMABLE PREFERRED STOCK PREFERRED STOCK STOCKHOLDER'S RIGHTS PLAN In October 1998, the Company adopted a stockholder's rights plan. Under the rights plan the Company distributed one preferred share purchase right for each outstanding share of Common Stock outstanding on November 6, 1998. Upon the occurrence of certain triggering events related to an unsolicited takeover attempt of the Company, each purchase right not owned by the party or parties making the unsolicited takeover attempt will entitle its holder to purchase shares of the Company's Series A Preferred Stock at a value below the then market value of the Series A Preferred Stock. The rights of holders of the Common Stock will be subject to, and may be adversely affected by, the rights of holders of the share 39 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS purchase rights, the Series A Preferred Stock and any other preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could make it more difficult for a third party to acquire a majority of the Company's outstanding voting stock. SERIES D PREFERRED STOCK PRIVATE PLACEMENT TRANSACTION On December 18, 2003, the Company sold an aggregate of 572,818 shares of non-voting Series D Convertible Preferred Stock, at a price of $44.00 per share, to institutional investors and individual accredited investors in a private placement transaction. The Company received net proceeds of $23,083,693 after commissions and other offering expenses. The Series D Convertible Preferred Stock was convertible after approval at a special meeting of stockholders at a rate of 10 common shares for each share of Series D Convertible Preferred Stock. Except as required by law, the Series D Preferred shares had no voting rights. The Series D Preferred shares accrued dividends, commencing on June 1, 2004, at an annual rate of 5% of the initial stated value of $44.00 per share, payable quarterly. In the event of a liquidation, dissolution or winding-up of the Company, the Series D Preferred shares would have been entitled to receive, prior to any distribution on the common stock, a distribution equal to the initial stated value of the shares plus all accrued and unpaid dividends. At a special meeting of stockholders held on February 11, 2004, the stockholders of the Company approved the issuance of 5,728,180 shares of common stock upon conversion of the Series D Preferred Stock. At the conclusion of the meeting, all of the shares of the Series D Convertible Preferred Stock automatically converted into common shares and the Series D Convertible Preferred Stock was eliminated. The Company has registered the common shares issued upon conversion of the Series D Convertible Preferred Stock for resale by the investors. In conjunction with the private placement transaction the Company issued a warrant to purchase 572,818 common shares to the placement agent at an exercise price of $4.74 per share. The warrant is exercisable beginning June 18, 2004 through December 18, 2008. The fair value of the warrant was estimated at approximately $165,000 utilizing the Black-Scholes model and was recorded as a reduction of the proceeds from the placement of the Series D Convertible Preferred Stock. The Company has determined that this transaction did not result in a beneficial conversion feature. SERIES C PREFERRED STOCK PURCHASE AGREEMENT AND CO-MARKETING AND SUPPLY AGREEMENT In accordance with the Series C Preferred Stock Purchase Agreement entered into with Coats North America Consolidated, Inc. ("Coats") on September 20, 2001, the Company issued 759,494 shares of Series C Convertible Redeemable Preferred Stock to Coats North America Consolidated, Inc. in exchange for an equity investment from Coats of $3,000,001 cash. The Series C Preferred shares were convertible at the option of the holder after one year at the rate of the closing price multiplied by 125% of the ten-day average closing price prior to closing. The Series C Preferred shares were redeemable at the option of the holder after four years. If the holders elected to redeem the Series C Preferred shares, the Company had the option to redeem for cash at the stated value of $3,000,001 or in the form of the Company's common stock at 85% of the market price of the Company's common stock on the date of redemption. If the market price of the Company's common stock on the date of redemption was less than $2.75 per share, the Company was required to redeem for cash at the stated value of the Series C Preferred shares. The Company could elect to redeem the Series C Preferred shares at any time for cash at the stated value. The terms of the Series C Preferred shares provided for cumulative dividends at a rate of 6% of the stated value per annum, payable in cash or the Company's common stock. The dividends were payable at the earlier of the declaration of the Board, conversion or redemption. Each Series C Preferred share had the right to vote for each of the Company's common shares that the Series C Preferred shares could then be converted into on the record date. Total legal and other costs associated with this transaction of $105,000 were netted against the $3,000,001 proceeds received from Coats. 40 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS In connection with the Series C Preferred Stock Purchase Agreement, the Company also entered into a 10-year Co-Marketing and Supply Agreement with Coats. The Co-Marketing and Supply Agreement provides for selected introductions into Coats' customer base and the Company's trim packages will exclusively offer thread manufactured by Coats. On February 25, 2004, the holders of the Series C Preferred Stock converted all 759,494 shares of Series C Preferred Stock, plus $458,707 of accrued dividends, into 700,144 shares of common stock. The Series C Preferred Stock was eliminated in March 2004. SERIES B PREFERRED STOCK PURCHASE AGREEMENT, DISTRIBUTION AGREEMENT AND TRADENAME PURCHASE AGREEMENT On April 3, 2000, the Company entered into a ten-year exclusive license and distribution agreement with Talon, Inc. and its parent company, Grupo Industrial Cierres Ideal, S.A. de C.V. ("GICISA"). Under this agreement, Tag-It Pacific, Inc. was the exclusive sales, marketing, distribution and e-commerce arm for "Talon" products for all customers in the United States, Mexico-based maquiladores, Canada and the Pacific Rim and had the exclusive license to market trim products under the "Talon" brand name. In exchange for these exclusive distribution rights, the Company issued 850,000 shares of Series B Convertible Preferred stock to GICISA. After a period of 30 months, the shares were convertible into the Company's common stock once the average price per share of the Company's common stock reached or exceeded $8.00 for a 30-day consecutive period. The preferred stock was automatically convertible into shares of the Company's common stock based on a rate of one minus the fraction of $2.50 over the average per share closing price of the Company's common stock for the 30-day period preceding the conversion. The Series B Convertible Preferred stock had a liquidation preference of $.001 per share, and was entitled to receive non-cumulative dividends on an as converted basis, if and when, such dividends were declared on the Company's common stock and was redeemable by the Company under certain conditions as outlined in the agreement. The estimated fair value of the Series B Convertible Preferred stock on April 3, 2000 was $1,400,000. The Company recorded the value of the license and distribution rights as a long-term asset, which was being amortized over the ten-year period of the agreement. The unamortized balance of the long-term asset at December 21, 2001 was $1,166,667. On September 30, 2000, the Company purchased inventory from GICISA in exchange for an unsecured note payable in the amount of $2,830,024. The note payable was non-interest bearing and was due April 1, 2002. The Company imputed interest for the holding period of the note amounting to $272,000. The note was subordinate to the obligations due under a credit facility with UPS Capital. The note payable balance at December 21, 2001 was $2,767,182, net of imputed interest of $62,842. On December 21, 2001, the Company entered into an Asset Purchase Agreement with Talon, Inc. and GICISA. Pursuant to the Asset Purchase Agreement, the Company acquired from Talon, Inc. and GICISA: (1) certain inventory and equipment, (2) all patent rights held by Talon, Inc. and (3) all of Talon's rights to its trade names and trademarks bearing the Talon name. In addition, the Asset Purchase Agreement terminated the exclusive 10-year license and distribution agreement, dated as of April 3, 2000 by and among the Company, GICISA and Talon, Inc. Under the Asset Purchase Agreement, the Company issued to Talon, Inc. 500,000 shares of common stock, par value $0.001 per share, a promissory note in the amount of $4,900,000 and $100,000 in cash held in escrow. The Asset Purchase Agreement required Talon, Inc. to place 50,000 shares of the Company's common stock and $100,000 in escrow for a period of 12 months to satisfy any indemnification claims the Company may have under the Asset Purchase Agreement. The common stock was valued at the market value of the Company's stock on the date of closing. The promissory note was unsecured, and accrued interest at 41 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS prime plus 2%. In connection with the Asset Purchase Agreement, the Company also entered into a mutual release with Talon, Inc. and GICISA pursuant to which Talon, Inc. and GICISA released the Company from its obligations under the unsecured note payable of $2,830,024 dated September 30, 2000 and other current liabilities under the Exclusive License and Distribution Agreement. Further, 850,000 shares of the Company's series B convertible preferred stock held by GICISA were canceled at the closing of the Asset Purchase Agreement. The balance of the unsecured promissory note was $1.4 million at December 31, 2004. The unsecured promissory note and all outstanding obligations due under the note payable were paid in full as of June 1, 2005. The Series B Convertible Preferred Stock was eliminated in February 2004. COMMON STOCK 2003 PRIVATE PLACEMENT On May 30, 2003, the Company raised approximately $6,037,500 in a private placement transaction with five institutional investors. Pursuant to a securities purchase agreement with these institutional investors, the Company sold 1,725,000 shares of its common stock at a price per share of $3.50. After commissions and expenses, the Company received net proceeds of approximately $5.5 million. The Company has registered the shares issued in the private placement with the Securities and Exchange Commission for resale by the investors. In conjunction with the private placement transaction, the Company issued warrants to purchase 172,500 shares of common stock to the placement agent. The warrants are exercisable beginning August 30, 2003 through May 30, 2008 and have a per share exercise price of $5.06. STOCK GRANT AGREEMENT Pursuant to Stock Grant Agreements between the Company and Herman Roup, dated December 1, 2001, January 1, 2002 and July 17, 2002, the Company issued to Mr. Roup an aggregate 20,500 shares of common stock in 2004 for services provided to the Company valued at $74,825. EXCLUSIVE LICENSE AND INTELLECTUAL PROPERTY RIGHTS AGREEMENT On April 2, 2002, the Company entered into an Exclusive License and Intellectual Property Rights Agreement (the "Agreement") with Pro-Fit Holdings Limited ("Pro-Fit"). The Agreement gives the Company the exclusive rights to sell or sublicense waistbands manufactured under patented technology developed by Pro-Fit for garments manufactured anywhere in the world for the United States market and all United States brands. In accordance with the Agreement, the Company issued 150,000 shares of its common stock which were recorded at the market value of the stock on the date of the Agreement. The shares contain restrictions related to the transfer of the shares and registration rights. The Agreement has an indefinite term that extends for the duration of the trade secrets licensed under the Agreement. The Company has recorded an intangible asset amounting to $577,500 and is amortizing this asset on a straight-line basis over its estimated useful life of five years. The Company is currently in litigation with this supplier (See Notes 1 and 13). NOTE 9 - STOCK OPTION INCENTIVE PLAN AND WARRANTS STOCK OPTION INCENTIVE PLAN On October 1, 1997, the Company adopted the 1997 Stock Incentive Plan (the "1997 Plan"), which authorized the granting of a variety of stock-based incentive awards. The Board of Directors, who determines the recipients and terms of the awards granted, administers the 1997 Plan. On July 31, 2006 at the 42 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Company's annual meeting of stockholder's two amendments to the 1997 Stock Plan were approved which (1) increased the maximum number of shares of common stock that may be issued pursuant to awards granted under the 1997 Plan from 3,077,500 shares to 6,000,000 shares, and (2) increased the number of shares of common stock that may be issued pursuant to awards granted to any individual under the plan in a single year to 50% of the total number of shares available under the plan. The Company believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Company's stock on the date of the grant for years prior to 2006, and for the year ended December 31, 2006, the average market price of the Company's stock for the five trading days prior to the date of the grant; those option awards generally vest over periods determined by the Board from immediate to 4 years of continuous service, and have 10 year contractual terms. As of December 31, 2006, the Company may issue awards to acquire up to a total of 2,321,977 shares of common stock under the 1997 Plan, and there were awards issued and outstanding under the Plan to acquire a total of 3,452,635 shares of common stock, including options issued to a consultant to acquire 75,000 shares of common stock at $0.57 per share. During 2006 the Company issued options outside the Plan to employees to acquire 1,625,000 shares of stock at an average exercise price of $0.46 per share, and granted 135,135 shares of stock to an employee with a fair market value of $50,000. The following table summarizes all options issued to employees and directors including those issued outside the plan. The following table summarizes the activity for the periods: Weighted Average Number of Exercise EMPLOYEE AND DIRECTOR Shares Price ------------- ------------- Options outstanding - January 1, 2004 .... 1,978,000 $ 3.55 Granted .... -- $ -- Exercised .... (115,375) $ 3.36 Canceled .... (120,625) $ 4.00 ------------- ------------- Options outstanding - December 31, 2004 .... 1,742,000 $ 3.53 Granted .... 425,000 $ 3.22 Exercised .... (1,250) $ 3.63 Canceled .... (332,750) $ 3.50 ------------- ------------- Options outstanding - December 31, 2005 .... 1,833,000 $ 3.46 Granted .... 3,471,135 $ 0.31 Canceled .... (301,500) $ 3.56 ------------- ------------- Options outstanding - December 31, 2006 .... 5,002,635 $ 1.41 ============= ============= The Company has also issued certain warrants and options to non-employees. As of December 31, 2006, there were warrants issued to acquire a total of 1,243,813 shares of common stock, and options to acquire 75,000 shares of common stock outstanding to non-employees. During 2006 the Company issued 90,253 shares of stock to a consultant in exchange for services with a fair market value of $51,000. 43 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The following table summarizes the activity for the periods: Weighted Average Number of Exercise NON-EMPLOYEES Shares Price ------------- ------------- Options & warrants outstanding - January 1, 2004 .... 1,277,885 $ 4.58 Granted .... 416,989 $ 3.65 Exercised .... (80,901) $ 2.68 Canceled .... (35,000) $ 4.55 ------------- ------------- Options & warrants outstanding - December 31, 2004 ..... 1,578,973 $ 4.35 Granted .... -- $ -- Exercised .... (68,494) $ 3.65 Canceled .... (133,332) $ 4.54 ------------- ------------- Options & warrants outstanding - December 31, 2005 ..... 1,377,147 $ 4.36 Granted .... 75,000 $ 0.57 Exercised .... -- $ -- Canceled .... (133,334) $ 4.54 ------------- ------------- Options & warrants outstanding - December 31, 2006 ..... 1,318,813 $ 4.13 ============= ============= The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model and the assumptions noted in the following table for the years ended December 31, as indicated. Expected volatilities are based on the historical volatility of the Company's stock price and other factors. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards, and actual and projected employee stock option exercise behaviors. The expected option term is estimated using the "safe harbor" provisions under SAB 107. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield in effect at the time of the grant. 2006 2005 2004(1) ------- ------- ------- Expected volatility .... 65% 64% n/a Expected term in years .... 6.1 yrs 1.2 yrs n/a Expected dividends .... -- -- n/a Risk-free rate .... 4.5% 2.0% n/a (1) No share-based grants were made in 2004. 44 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS A summary of the option activity under the 1997 Plan as of December 31, 2006, and changes during the year then ended is as follows: Weighted Weighted Average Average Remaining Number of Exercise Contractual Intrinsic EMPLOYEE AND DIRECTOR Shares Price Life (Years) Value ------------ ------------ ------------ ------------ Outstanding at December 31, 2006 ...... 5,002,635 $ 1.41 7.90 $ 1,875,639 Vested and Expected to Vest .... 4,927,355 $ 1.43 7.88 $ 1,837,150 Exercisable .... 2,223,968 $ 2.51 6.25 $ 447,389 The weighted average grant-date fair value of options granted to employee's and director's during the years ended December 31, 2006 and 2005 were $0.31 and $0.76, respectively. There were no grants in 2004. The total intrinsic value of options exercised during the years ended December 31, 2005 and 2004 was $1,700, and $130,000, respectively. There were no options exercised in 2006. Weighted Weighted Average Average Remaining Number of Exercise Contractual Intrinsic NON-EMPLOYEE OPTIONS & WARRANTS: Shares Price Life (Years) Value ------------ ------------ ------------ ------------ Outstanding at December 31, 2006 1,318,813 $ 4.13 2.28 $ 34,500 Vested and Expected to Vest.... 1,318,813 $ 4.13 2.28 $ 34,500 Exercisable....................... 1,318,813 $ 4.13 2.28 $ 34,500 The weighted average grant-date fair value of options and warrants granted to non-employees during the years ended December 31, 2006, and 2004 was $0.57 and $3.70, respectively. There were no grants in 2005. The total intrinsic value of options and warrants exercised during the years ended December 31, 2005 and 2004 was $91,000 and $135,000, respectively. There were no options exercised in 2006. The fair value of the awards approximates the values expensed for pro-forma purposes for these periods. As of December 31, 2006, there was $645,248 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted, including warrants. This cost is expected to be recognized over the weighted-average period of 2.0 years. The total fair value of shares vested during the years ended December 31, 2006, 2005 and 2004 was $236,000, $217,000 and $1,597,000, respectively. When options are exercised, the Company's policy is to issue previously registered, unissued shares of common stock. As of December 31, 2006, the Company had 2,321,977 unissued shares of common stock available in its 1997 Plan. On July 31, 2006, at the annual shareholders meeting an amendment to the 1997 Stock Incentive Plan was adopted to increase the number of authorized shares under the 1997 Plan to a total of 6,000,000 shares. The additional plan shares authorized on July 31, 2006 of 2,922,500 shares have not yet been registered. 45 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 10 - INCOME (LOSS) PER SHARE The following is a reconciliation of the numerators and denominators of the basic and diluted income (loss) per share computations: December 31, 2006 December 31, 2005 -- -- Income Shares Per Share Loss Shares Per Share YEARS ENDED: (Numerator) (Denominator) Amount (Numerator) (Denominator) Amount ------------------- ------------ ------------ ------------ ------------ ------------ ------------ Basic income (loss): Income (loss) available to common stockholders ... $ 309,303 18,377,484 $ 0.02 $(29,537,70) 18,225,851 $ (1.62) Effect of dilutive securities: Options .... -- 578,312 0.00 -- -- -- Warrants .... -- -- -- -- -- -- ------------ ------------ ------------ ------------ ------------ ------------ Income (loss) available to common stockholders .... $ 309,303 18,955,796 $ 0.02 $(29,537,70) 18,225,851 $ (1.62) ============ ============ ============ ============ ============ ============ December 31, 2004 -- Loss Shares Per Share YEARS ENDED: (Numerator) (Denominator) Amount ------------------- ------------ ------------ ------------ Basic income (loss): Income (loss) available to common stockholders ... $(17,639,47) 17,316,202 $ (1.02) Effect of dilutive securities: Options .... -- -- -- Warrants .... -- -- -- ------------ ------------ ------------ Income (loss) available to common stockholders .... $(17,639,47) 17,316,202 $ (1.02) ============ ============ ============ Warrants to purchase 1,243,813 shares of common stock at between $3.50 and $5.06; options to purchase 1,642,500 shares of common stock at between $1.27 and $5.23; convertible debt of $12,500,000 convertible at $3.65 per share, and other convertible debt of $500,000 convertible at $4.50 per share were outstanding for the year ended December 31, 2006, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on the income per share. Warrants to purchase 1,377,147 shares of common stock at between $3.50 and $5.06, options to purchase 1,833,000 shares of common stock at between $0.41 and $5.23, convertible debt of $12,500,000 convertible at $3.65 per share, and other convertible debt of $500,000 convertible at $4.50 per share were outstanding for the year ended December 31, 2005, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share. Warrants to purchase 1,578,973 shares of common stock at between $3.50 and $5.06, options to purchase 1,742,000 shares of common stock at between $1.30 and $4.63, convertible debt of $12,500,000 convertible at $3.65 per share, and other convertible debt of $500,000 convertible at $4.50 per share were outstanding for the year ended December 31, 2004, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share. NOTE 11 - 2005 RESTRUCTURING PLAN In an effort to better align the Company's organizational and cost structures with its future growth opportunities, in August 2005 the Company's Board of Directors adopted a restructuring plan for the Company that was substantially completed by December 2005. The plan included restructuring the Company's global operations by eliminating redundancies in its Hong Kong operation, closing its Mexican facilities, converting its Guatemala facility from a manufacturing site to a distributor, and closing its North Carolina manufacturing facility. The Company also refocused its sales efforts on higher margin products, which may have resulted in lower net sales with certain customers. As a result, the Company now operates with fewer employees and reduced associated operating and manufacturing expenses. The Company recorded charges in connection with its restructuring plan in accordance with SFAS No. 146 (As Amended), "Accounting for Costs Associated with Exit or Disposal Activities." In addition, the Company's restructuring plan resulted in the carrying value of certain long-lived assets, primarily equipment, being impaired. Accordingly, in 2005 the Company recorded a charge to recognize the impairment of these assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets. 46 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The North Carolina manufacturing facility is a long-lived asset that is classified as "held for sale" because it meets the criteria listed in Paragraph 30 of SFAS 144. Management has committed to sell the asset, and is listing the property for sale with a commercial real estate agent. The Company believes the sale of the asset is probable and the sale is expected to be completed within one year. The major components of manufacturing equipment used in this plant to manufacture zippers are not classified as held for sale since the Company intends to re-deploy this equipment in the manufacture of Talon zippers through investment or sale of this equipment to its distributors of Talon zippers. This equipment is separately identified as idle equipment as a component of "Property and equipment" which are included in the accompanying consolidated balance sheets (See Note 1). Restructuring costs recorded in 2005 were $6,371,000. Restructuring costs include $3,447,000 of inventory write-downs, restructuring charges of $2,474,000 consisting of $2,036,000 for the impairment of long-lived assets, primarily machinery and equipment, $170,000 of one-time employee termination benefits and other costs of $268,000, which were fully paid by the end of 2005. In addition, an impairment charge to goodwill in the amount of $450,000 was recorded. This goodwill was associated with an acquisition made to benefit the Central and South American operations. Since these operations are being exited, management concluded that this goodwill was impaired and should be written off. These restructuring costs were recorded in the Consolidated Statement of Operations for the year ended December 31, 2005 in the following line items and amounts: Cost of goods sold .... $3,447,000 Operating expenses: General & administrative expenses .... 450,000 Restructuring charges .... 2,474,000 ---------- Total restructuring costs .... $6,371,000 ========== NOTE 12 - INCOME TAXES The components of the provision (benefit) for income taxes included in the consolidated statements of operations are as follows: Year Ended December 31, -- 2006 2005 2004 ---------- ---------- ---------- Current: Federal .... $ 29,900 $ 55,479 $ 405,632 State .... 4,000 4,000 71,582 ---------- ---------- ---------- 33,900 59,479 477,214 Deferred: Federal .... -- 850,000 1,530,000 State .... -- 150,000 270,000 ---------- ---------- ---------- -- 1,000,000 1,800,000 ---------- ---------- ---------- $ 33,900 $1,059,479 $2,277,214 ========== ========== ========== 47 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS A reconciliation of the statutory Federal income tax rate with the Company's effective income tax rate is as follows: Year Ended December 31, --------------------------- 2006 2005 2004 ------ ------ ------ Current: Federal statutory rate .... 34.0% (34.0)% (34.0)% State taxes net of federal benefit .... 2.3 (5.8) (6.0) Income earned from foreign subsidiaries ..... 18.7 0.2 3.1 Net operating loss valuation allowance adjustments .... (71.7) 43.5 51.3 Change in effective state tax rate .... 22.4 -- -- Other .... 4.2 (0.2) 0.5 ------ ------ ------ 9.9% 3.7% 14.9% ====== ====== ====== Income (loss) before income taxes is as follows: Year Ended December 31, -- 2006 2005 2004 ------------ ------------ ------------ Domestic .... $ (1,341,475) $(28,724,518) $(17,574,926) Foreign .... 1,684,678 246,288 2,243,172 ------------ ------------ ------------ $ 343,203 $(28,478,230 $(15,331,754) ============ ============ ============ The primary components of temporary differences which give rise to the Company's deferred tax assets and deferred tax liabilities are as follows: Year Ended December 31,

------------------------------ 2006 2005 ------------ ------------ Net deferred tax asset: Net operating loss carry-forwards ..... $ 19,053,346 $ 20,820,849 Depreciation and amortization .... (551,643) (442,909) Bad debt reserve .... 17,961 403,494 Related party interest .... 189,605 160,996 Inventory reserve .... 289,813 448,674 Other .... 225,656 56,343 ------------ ------------ 19,224,738 21,447,447 Less: Valuation Allowance .... (19,224,738) (21,447,447) ------------ ------------ $ -- $ -- ============ ============ At December 31, 2006, Tag-It Pacific, Inc. had Federal and state net operating loss carry-forwards (or "NOLs") of approximately $53.6 million and $13.9 million, respectively. The Federal NOL is available to offset future taxable income through 2024, and the state NOL expires in 2014. Section 382 of the Internal Revenue Code places a limitation on the realizability of net operating losses in future periods if the ownership of the Company has changed more than 50% within a three-year period. As of December 31, 2006, some of our net operating losses may be limited by the Section 382 rules. The amount of such limitations, if any, has not yet been determined. Income taxes are accounted for under the asset and liability 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 48 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS bases and tax benefit carry-forwards. Deferred tax liabilities and assets at the end of each period are determined using enacted tax rates. The Company records deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if it believes that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. The provisions of SFAS No. 109, "Accounting for Income Taxes," require the establishment of a valuation allowance when, based on currently available information and other factors, it is more likely than not that all or a portion of a deferred tax asset will not be realized. SFAS No. 109 provides that an important factor in determining whether a deferred tax asset will be realized is whether there has been sufficient income in recent years and whether sufficient income is expected in future years in order to utilize the deferred tax asset. In 2006 and in prior years, the Company determined, based upon its cumulative operating losses, that it was more likely than not that it would not be in a position to fully realize all of its deferred tax assets in future years. Accordingly, at December 31, 2006 the Company has recorded a valuation allowance of $19.2 million, which reduces the carrying value of its net deferred tax assets to $0. For the year ended December 31, 2006 the Company recorded operating income and various rate and tax timing differences and the value of its net deferred tax assets declined by $2.2 million. Accordingly, a corresponding reduction in the valuation allowance was made, which retained the carrying value of the Company's net deferred tax assets at $0. During 2005 the Company incurred additional operating losses which resulted in an increase in the Company's net deferred tax assets by $11.5 million. Accordingly, it was determined that the valuation allowance from 2004 be increased by $12.5 million to $21.4 million, which reduced the carrying value of its net deferred tax assets to $0 at December 31, 2005. In 2004 the Company recorded a valuation allowance of $8.9 million based upon its cumulative operating losses, and reduced the carrying value of its net deferred tax asset to $1.0 million at December 31, 2004. The Company intends to maintain a valuation allowance for its deferred tax assets until sufficient evidence exists to support the reversal or reduction of the allowance. At the end of each period, the Company will review supporting evidence, including the performance against sales and income projections, to determine if a release of the valuation allowance is warranted. If in future periods it is determined that it is more likely than not that the Company will be able to recognize all or a greater portion of its deferred tax assets, the Company will at that time reverse or reduce the valuation allowance. The Company believes that its estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on its balance sheet and results of operations. The Company has not provided withholding of U.S. federal income taxes on undistributed earnings of its foreign subsidiaries because the Company intends to reinvest those earnings indefinitely or any taxes on these earnings will be offset by the approximate credits for foreign taxes paid. It is not practical to determine the U.S. federal tax liability, if any, which would be payable if such earnings were not invested indefinitely. At December 31, 2006 and 2005, undistributed earnings from our foreign subsidiaries were $4,581,000 and $4,689,000, respectively. 49 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 13 - COMMITMENTS AND CONTINGENCIES OPERATING LEASES The Company is a party to a number of non-cancelable operating lease agreements involving buildings and equipment, which expire at various dates through 2010. The Company accounts for its leases in accordance with SFAS No. 13, whereby step provisions, escalation clauses, tenant improvement allowances, increases based on an existing index or rate, and other lease concessions are accounted for in the minimum lease payments and are charged to the income statement on a straight-line basis over the related lease term. The future minimum lease commitments at December 31, 2006 are as follows: Years Ending December 31, Amount -- ---------- 2007 .... $ 437,226 2008 .... 407,224 2009 .... 346,184 2010 .... 213,364 2011 and thereafter .... 16,757 ---------- Total minimum payments .... $1,420,755 ========== Total rental expense for the years ended December 31, 2006, 2005 and 2004 aggregated $640,864, $750,536, and $696,590, respectively. PROFIT SHARING PLAN In October 1999, the Company established a 401(k) profit-sharing plan for the benefit of eligible employees. The Company may make annual contributions to the plan as determined by the Board of Directors. Total contributions for the years ended December 31, 2006 and 2005 amounted to $22,276 and $16,807, respectively. There were no contributions made during the year ended December 31, 2004. CONTINGENCIES In May, 2006, the Company received notice from the American Stock Exchange ("AMEX") that it was not in compliance with certain of the continued listing standards as set forth in the AMEX Company Guide due to the failure to comply with Section 1003(a)(i) and Section 1003(a)(ii) of the Company Guide, which effectively required that the Company maintain shareholders' equity of at least $4,000,000. Following the notice from AMEX the Company was afforded the opportunity to submit a "plan of compliance" to AMEX outlining in detail how the Company expected to achieve the minimum equity requirements and to regain compliance. On August 3, 2006 the Company received notification from AMEX that the Company's plan to regain compliance with the minimum shareholders' equity requirements of the AMEX Company Guide had been accepted and the Company has been granted an extension until November 16, 2007 to achieve the AMEX continued listing requirements. During this period the Company will be subject to periodic review by the AMEX Staff and failure to make progress consistent with the plan or to regain compliance with continued listing standards by the end of the extension period could result in being delisted from the American Stock Exchange. On October 12, 2005, a shareholder class action complaint-- Huberman v. Tag-It Pacific, Inc., et al., Case

No. CV05-7352 R(Ex)--was filed against us and certain of our current and former officers and directors in the United States District Court for the Central District of California alleging claims under Section 10(b) and Section 20 of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The action is brought on behalf of all 50 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS purchasers of our publicly-traded securities during the period from November 14, 2003 to August 12, 2005. On January 23, 2006 the court heard competing motions for appointment of lead plaintiff/counsel and appointed Seth Huberman as lead plaintiff. The lead plaintiff thereafter filed an amended complaint on March 13, 2006. The amended complaint alleges that defendants made false and misleading statements about the company's financial situation and its relationship with certain of its large customers during a purported class period between November 13, 2003 and August 12, 2005. It purports to state claims under Section 10(b)/Rule 10b-5 and Section 20(a) of the Securities Exchange Act of 1934. The Company filed a motion to dismiss the amended complaint, which motion was denied by the court on July 17, 2006. On December 21, 2006 the court established a trial date of May 1, 2007 and ordered completion of discovery by March 19, 2007. On February 20, 2007 the court denied class certification. Plaintiff has moved the court to reconsider the ruling, and also to intervene a new plaintiff to pursue class certification. Both of those motions were denied on April 2, 2007. In addition, the same day, the Court granted Defendants' motion for summary judgment, and it is anticipated that the Court will enter a judgment in favor of all Defendants shortly. It is possible that Plaintiff will appeal the summary judgment and class certification rulings. The Company believes that this matter will be resolved in trial or in settlement within the limits of its insurance coverage, however the outcomes of this action or an estimate of the potential losses, if any, related to the lawsuit cannot be reasonably predicted, and an adverse resolution of any of the lawsuit could potentially have a material adverse effect on our financial position and results of operations. On April 16, 2004 the Company filed suit against Pro-Fit Holdings, Limited ("Pro-Fit") in the U.S. District Court for the Central District of California -- Tag-It Pacific, Inc. v. Pro-Fit Holdings, Limited, CV 04-2694 LGB (RCx) -- asserting various contractual and tort claims relating to our exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. It is the Company's position that the agreement with Pro-Fit gives us the exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. On September 17, 2004, Pro-Fit filed an answer denying the material allegations of the complaint and filed counterclaims alleging various contractual and tort claims seeking injunctive relief and damages. We filed a reply denying the material allegations of Pro-Fit's pleading. Pro-Fit has since purported to terminate the exclusive license and intellectual property agreement based on the same alleged breaches of the agreement that are the subject of the parties' existing litigation, as well as on an additional basis. On February 9, 2005, and again on June 16, 2005, we amended our pleadings in the litigation to assert additional breaches by Pro-Fit of its obligations under the agreement and under certain additional letter agreements, and for a declaratory judgment that Pro-Fit's patent No. 5,987,721 is invalid and not infringed by us. Thereafter, Pro-Fit filed an amended answer and counterclaims denying the material allegations of the amended complaint and alleging various contractual and tort claims seeking injunctive relief and damages. Pro-Fit further asserted that we infringed its United States Patent Nos. 5,987,721 and 6,566,285. We filed a reply denying the substantive allegations of the amended counterclaims. On June 5, 2006 the Court denied the Company's motion for partial summary judgment holding that summary adjudification that we did not breach our agreement with Pro-Fit by engaging in certain activities in Columbia was not appropriate. The Court also held that Pro-Fit was not "unwilling or unable" to fulfill orders by refusing to fill orders with goods produced in the United States. The Court did not find that we breached our agreement with Pro-Fit and a trial is required to determine issues concerning our activities in Columbia and whether other actions by Pro-Fit constituted an unwillingness or inability to fill orders. As a result of a change in the law, we dismissed our antitrust claims against Pro-Fit. The court has not yet set a date for trial of this matter. We derive a significant amount of revenue from the sale of products incorporating the stretch waistband technology our business, results of operations and financial condition could be materially adversely affected if the dispute with Pro-Fit is not resolved in a manner favorable to us. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial. Tag-It Pacific, Inc. has agreements with its foreign subsidiaries that provide for royalty payments to the U.S. parent company for the sales of products carrying the Talon(R) brand name, and that also provide for a cost sharing arrangement associated with various corporate administrative and operations support costs. These agreements may give rise to inquiries and 51 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS possible disputes by the foreign taxing authority, resulting in the possible disallowance of some of these costs and potentially resulting in higher foreign income taxes than has been provided. The Company believes that its basis of charging these royalties and its allocation of costs to foreign subsidiaries is appropriate under the various taxing agency laws, and that any disagreement or disallowance regarding such costs will not have a material affect on the financial statements of the Company. A subsidiary, Tag-It de Mexico, S.A. de C.V., has operated under the Mexican government's Maquiladora Program, which entitles Tag-It de Mexico to certain favorable treatment as respects taxes and duties regarding certain imports. In July of 2005, the Mexican Federal Tax Authority asserted a claim against Tag-It de Mexico alleging that certain taxes had not been paid on imported products during the years 2000, 2001, 2002 and 2003. In October of 2005, the Company filed a procedural opposition to the claim and submitted documents to the Mexican Tax Authority in opposition to this claim, supporting the Company's position that the claim was without merit. The Mexican Federal Tax Authority failed to respond to the opposition filed, and the required response period by the Tax Authority has lapsed. In addition, a controlled entity incorporated in Mexico (Logistica en Avios, S.A. de C.V.) through which the Company conducted its operations in 2005, may be subjected to a claim or claims from the Mexican Tax Authority, as identified directly above, and additionally to other tax issues, including those arising from employment taxes. The Company believes that any such claim is defective on both procedural and documentary grounds and is without merit. An estimate of the possible loss or range of loss if any associated with these matters cannot be made at this time. The Company does not believe these matters will have a material adverse affect on the Company. The Company currently has pending a number of other claims, suits and complaints that arise in the ordinary course of our business. We believe that we have meritorious defenses to these claims and that the claims are either covered by insurance or, after taking into account the insurance in place, would not have a material effect on our consolidated financial condition if adversely determined against us. In November 2002, the FASB issued FIN No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others - and interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34." The following is a summary of the Company's agreements that it has determined are within the scope of FIN 45: In accordance with the bylaws of the Company, officers and directors are indemnified for certain events or occurrences arising as a result of the officer or director's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws is minimal and therefore, the Company has not recorded any related liabilities. The Company enters into indemnification provisions under its agreements with investors and its agreements with other parties in the normal course of business, typically with suppliers, customers and landlords. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by the Company with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities. 52 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 14 - GEOGRAPHIC AND PRODUCT GROUP INFORMATION The Company specializes in the distribution of a full range of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. There is not enough difference between the types of products developed and distributed by the Company to justify segmented reporting by product type. The Company believes that revenue by each major product class is a valuable business measurement. The net revenues for the three primary product groups is as follows: Year Ended December 31, -- 2006 2005 2004 ----------- ----------- ----------- Product Group Net Revenue: Talon zipper .... $17,005,203 $13,593,479 $12,712,689 Trim .... 22,502,947 24,788,397 28,805,347 Tekfit .... 9,316,852 8,949,300 13,591,445 ----------- ----------- $48,825,002 $47,331,176 $55,109,481 =========== =========== =========== The Company distributes its products internationally and has reporting requirements based on geographic regions. Long-lived assets are attributed to countries based on the location of the assets and revenues are attributed to countries based on customer delivery locations, as follows: Year Ended December 31, -- 2006 2005 2004 ----------- ----------- ----------- Sales: United States .... $ 5,287,236 $ 8,902,734 $ 4,822,935 Asia .... 28,974,546 20,005,036 12,785,977 Mexico .... 2,476,313 8,526,367 21,452,805 Dominican Republic .... 9,138,404 5,914,792 9,678,078 Other .... 2,948,503 3,982,247 6,369,686 ----------- ----------- ----------- $48,825,002 $47,331,176 $55,109,481 =========== =========== =========== Long-lived Assets: United States .... $ 9,531,659 $ 9,797,110 $12,911,377 Asia .... 386,516 226,221 234,746 Mexico .... 5,078 23,754 187,721 Dominican Republic .... 668,067 776,279 866,807 ----------- ----------- ----------- $10,591,320 $10,823,364 $14,200,651 =========== =========== =========== NOTE 15 - MAJOR CUSTOMERS AND VENDORS For the year ended December 31, 2006, no single customer represented more than 9% of the Company's consolidated net sales; however the Company's three largest customers represented approximately 18% of consolidated net sales. For the year ended December 31, 2005, no single customer represented more than 10% of consolidated net sales; however, the Company's three largest customers represented approximately 22% of consolidated net sales. Two major customers accounted for approximately 22% of the Company's net sales for the year ended December 31, 2004. One major vendor accounted for substantially all of the Company's purchases associated with its TekFit product for the year ended December 31, 2006 and represented 24% of the Company's overall purchases; and three vendors, each representing more than 10% of the Company's purchases, accounted for approximately 45% of the Company's purchases for the year ended December 31, 2006. Three vendors accounted for approximately 39% of the Company's purchases for the year ended December 31, 2005, and four vendors accounted for approximately 70% of the Company's purchases for the year ended December 31, 53 TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS 2004. Included in accounts payable and accrued expenses at December 31, 2006 and 2005 is $2,682,000 and $2,206,000 due to these vendors. Terms are sight to 60 days. NOTE 16 - RELATED PARTY TRANSACTIONS Prior to 2004 the Company operated an apparel trim supply agreement with Tarrant Apparel Group. Two of Tarrant's directors and significant shareholders are also significant shareholders of the Company. In 2004, following negotiations with Tarrant Apparel Group, the Company determined that a significant portion of the obligations due from this customer were uncollectible. Accordingly, included in general and administrative expenses for 2004 are charges of $4.3 million related primarily to the write-down of this receivable and leaving a remaining balance receivable from this customer of $4.5 million at December 31, 2004. An affiliate of the customer repaid the $4.5 million receivable balance over the period from May through December 2005. The Company terminated its supply relationship with Tarrant in 2004; however the Company continues to conduct business with Tarrant on a limited basis. Total sales to Tarrant for the years ended December 31, 2006, 2005 and 2004 were $3,000, $574,000 and $758,000, respectively. As of December 31, 2005, accounts receivable, related party included $0.05 million due from Tarrant. No amounts were due from Tarrant at December 31, 2006. Colin Dyne, a director of the Company is a significant shareholder in People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. During 2006 and 2005 the Company had sales of $147,000 and $ 76,000 respectively, to Versatile Entertainment. At December 31, 2006 accounts receivable of $83,400 were outstanding from Versatile Entertainment. Due from related parties at December 31, 2006 and 2005 includes $675,137 and $655,489 respectively, of unsecured notes, advances and accrued interest receivable from Colin Dyne,. The notes and advances bear interest at 7.5% and are due on demand. Demand notes payable to related parties includes notes and advances to Mark Dyne, the Chairman of the Board of Directors of the Company or to parties related to or affiliated with Mark Dyne. The balance of Demand notes payable to related parties at December 31, 2006 and 2005 was $664,971. See Note 4 for further discussion of these notes, and related accrued interest and interest expense. Transportation fees in the amount of $211,000 were paid to or on behalf of a company that Mark Dyne has an ownership interest in for the year ended December 31, 2004. Consulting fees paid to Diversified Investments, a company owned by Mark Dyne, amounted to $150,000 for each of the years ended December 31, 2006, 2005 and 2004. Consulting fees of $335,000 were paid for services provided by Colin Dyne, for the year ended December 31, 2006. Brent Cohen and Raymond Musci, both members of the Board of Directors were paid for services provided during the year ended December 31, 2005 in the amount of $24,000, and $21,000, respectively. Mr. Cohen and Kevin Bermiester, a former director of the Company, were paid for services provided during the year ended December 31, 2004 in the amounts of $57,000 and $41,000, respectively. 54 TAG-IT PACIFIC, INC. NOTES

TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 17 - QUARTERLY RESULTS (UNAUDITED) Quarterly results for the years ended December 31, 2006 and 2005 are reflected below: 4th 3rd 2nd 1st ------------ ------------ ------------ ------------ 2006 ---- Revenue .... $ 10,573,755 $ 13,366,944 $ 14,246,087 $ 10,638,216 Gross profit .... $ 3,350,600 $ 4,148,406 $ 4,127,237 $ 2,842,725 Operating income (loss) .... $ 248,177 $ 630,273 $ 895,481 $ (442,275) Net Income(loss) .... $ 44,950 $ 339,115 $ 654,643 $ (729,404) Basic and diluted income (loss) per share .... $ 0.00 $ 0.02 $ 0.04 $ (0.04) 2005 ---- Revenue .... $ 9,163,355 $ 9,472,898 $ 15,639,646 $ 13,055,277 Gross profit (loss) (1) .... $ (1,652,918) $ (2,094,230) $ 756,120 $ 3,251,823 Operating (loss) income (1,2) .... $ (4,925,076) $(10,203,361) $(10,829,928) $ (1,140,089) Net (loss) income (1,2) .... $ (5,127,754) $(10,284,874) $(12,476,638) $ (1,648,443) Basic and diluted (loss) per share .... $ (0.28) $ (0.56) $ (0.68) $ (0.09) (1) The Company recorded restructuring charges of $6.2 million in the third quarter of 2005, of which $3.4 million, related to inventory write-downs (Note 11); theCompany recorded $2.5 million in inventory obsolescence reserves and $1.5 million in inventory overhead adjustments in the fourth quarter affecting gross profit. (2) The Company recorded $3.6 million in bad debt reserves principally associated with one customer in the second quarter of 2005; direct write-off to bad debts of $1.8 million in the third quarter of 2005 principally from another customer, and $0.5 million in bad debts in the fourth quarter of 2005 associated with the acceptance of a note receivable. In the third quarter of 2005, the Company recorded restructuring charges included in operating costs of $2.8 millionand a decrease in net deferred tax asset resulting in a charge to the provision for income taxes of $1 million during 2005. During 2006, the Company had no material unusual or infrequently occurring items or adjustments that were recognized during the year. Quarterly and year-to-date computations of per share amounts are made independently. Therefore, the sum of per share amounts for the quarters may not agree with the per share amounts for the year. NOTE 18 - SUBSEQUENT EVENT (UNAUDITED) On April 11, 2007 a favorable verdict was awarded to the plaintiff in a trademark infringement lawsuit in which Azteca Production International, Inc. is a defendant. We have an outstanding note receivable from Azteca (see Note 2), and this adverse ruling against them may impact their ability to repay our note receivable. The outcome of this event or an estimate of the potential impact if any, on the collectibility of our note receivable cannot be reasonably predicted at this time. The failure to collect payments under this note as scheduled could have a material adverse effect on our financial position and results of operations. 55 ITEM 9A. CONTROLS AND PROCEDURES EVALUATION OF CONTROLS AND PROCEDURES We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. As of December 31, 2006, we conducted an evaluation, with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of December 31, 2006, our disclosure controls and procedures were effective. CHANGES IN INTERNAL CONTROLS During the last fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. 56 PART IV ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (a) FINANCIAL STATEMENTS AND SCHEDULES. 57 INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S REPORT ON SCHEDULE II To the Board of Directors Tag it Pacific, Inc. Woodland Hills, California The audits referred to in our report, dated April 9, 2007 included in the related financial statement schedule as of December 31, 2006 and for the two years ended December 31, 2006, included in the annual report on Form 10-K of Tag-It Pacific, Inc. This financial statement scheduled is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audit. In our opinion, such financial statement schedule presents fairly, in all material respects, the information set forth therein. /S/ SINGER LEWAK GREENBAUM & GOLDSTEIN LLP --- SINGER LEWAK GREENBAUM & GOLDSTEIN LPP Los Angeles, California April 9, 2007 58 INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S REPORT ON SCHEDULE II To the Board of Directors Tag-It Pacific, Inc. Los Angeles, California The audit referred to in our report, dated March 31, 2005, included the related financial statement schedule as of and for the year ended December 31, 2004 included in the annual report on Form 10-K of Tag-It Pacific, Inc. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audit. In our opinion, such financial statement schedule presents fairly, in all material respects, the information set forth therein. /s/ BDO Seidman, LLP ------------------------ BDO Seidman, LLP Los Angeles, California March 31, 2005 59 SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES COLUMN A COLUMN B COLUMN C COLUMN D COLUMN E Balance at Beginning Balance at Description of Year Additions Deductions End of Year --- ----------- ----------- ----------- ----------- 2006 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 1,189,000 $ 198,000 $ 1,315,500 $ 71,500 Reserve for obsolescence deducted from inventories on the balance sheet .... 7,306,000 557,000 6,621,000 1,242,000 Valuation reserve deducted from deferred tax assets .... 21,447,000 -- 2,222,000 19,225,000 ----------- ----------- ----------- ----------- $29,942,000 $ 755,000 $10,158,500 $20,538,500 =========== =========== =========== =========== 2005 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 6,086,000 $ 4,160,000 $ 9,057,000 $ 1,189,000 Reserve for obsolescence deducted from inventories on the balance sheet .... 6,365,000 2,538,000 1,597,000 7,306,500 Valuation reserve deducted from deferred tax assets .... 8,900,000 12,547,000 -- 21,447,000 ----------- ----------- ----------- ----------- $21,351,000 $19,245,000 $10,654,000 $29,942,000 =========== =========== =========== =========== 2004 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 2,044,000 $ 5,500,000 $ 1,458,000 $ 6,086,000 Reserve for obsolescence deducted from inventories on the balance sheet .... 6,125,000 1,040,000 800,000 6,365,500 Valuation reserve deducted from deferred tax assets .... 1,119,000 7,781,000 -- 8,900,000 ----------- ----------- ----------- ----------- $ 9,288,000 $14,321,000 $ 2,258,000 $21,351,000 =========== =========== =========== =========== (1) Additions to the allowance for doubtful accounts include provisions for uncollectible accounts. Bad debt expense includes (and additions above exclude) net recoveries of $712,000 for the year ended December 31, 2006, and net direct write-offs of $1,698,000 and $7,012,000 for the years ended

December 31, 2005 and 2004, respectively. Additions to the inventory obsolescence reserve include current year provisions. In 2005 there were direct write-offs of inventory of $3.4 million in connection with the restructuring, and in 2006 there were direct write-offs of $0.2 million. The reserve for obsolescence deducted from inventories on the balance sheet for 2004, reflects the reclassification of $1.2 million previously reported in Column D as a deduction, to Column C as net additions consistent with the presentation in 2005 and 2006. (2) Deductions from the allowance for doubtful accounts includes amounts applied to write-offs, reversals of prior period provisions, and, for the year ended December 31, 2005, deductions include $7,528,000 related to the conversion of a trade account receivable to a note receivable. Deductions from the inventory obsolescence reserve include application of the reserve against obsolete, excess, slow-moving or disposed inventory. (b) EXHIBITS: See Exhibit Index attached to this Annual Report of Form 10-K. 60 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. TALON INTERNATIONAL, INC. /s/ Lonnie D. Schnell --------------------------- By: Lonnie D. Schnell Its: Chief Executive Officer SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. Signature Title Date --------- ----- ---- * Chairman of the Board of Directors March 14, 2008 --------------------- Mark Dyne /s/ Lonnie D. Schnell Chief Executive Officer and Chief March 14, 2008 --------------------- Financial Officer (Principal Lonnie D. Schnell Executive and Financial Officer) /s/ David Hunter Vice President Corporate Controller March 14, 2008 --------------------- (Principal Accounting Officer) David Hunter * Director March 14, 2008 --------------------- Colin Dyne Director March 14, 2008 --------------------- Brent Cohen * Director March 14, 2008 --------------------- Raymond Musci * Director March 14, 2008 --------------------- Joseph Miller * Director March 14, 2008 --------------------- William Sweedler By: /s/ Lonnie D. Schnell ---------------------------------- Lonnie D. Schnell, Attorney-In-Fact 61 EXHIBIT INDEX Exhibit Number Exhibit Description ------- --- 23.1 Consent of Singer Lewak Greenbaum & Goldstein LLP. 23.2 Consent of BDO Seidman, LLP. 31.1 Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended 31.2 Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended 32.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended. 62