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TAG IT PACIFIC INC  
Form 10-K  
April 13, 2007

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 1-13669

TAG-IT PACIFIC, INC.  
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

95-4654481  
(I.R.S. Employer  
Identification No.)

21900 BURBANK BLVD., SUITE 270  
WOODLAND HILLS, CALIFORNIA 91367  
(Address of Principal Executive Offices) (Zip Code)

(818) 444-4100  
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange On Which Registered
Common Stock, \$.001 Par Value	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registration is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for past 90 days.

Yes  No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer [ ] Accelerated filer [ ]
Non-accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

At June 30, 2006 the aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant was \$12,147,000. At April 10, 2007 the issuer had 18,466,433 shares of Common Stock, \$.001 par value, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the issuer's proxy statement with respect to its 2007 annual meeting of stockholders are incorporated by reference into Part III of this report.

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## FORWARD LOOKING STATEMENTS

This report and other documents we file with the SEC contain forward looking statements that are based on current expectations, estimates, forecasts and projections about us, our future performance, our business or others on our behalf, our beliefs and our management's assumptions. In addition, we, or others on our behalf, may make forward looking statements in press releases or written statements, or in our communications and discussions with investors and analysts in the normal course of business through meetings, webcasts, phone calls, and conference calls. Words such as "expect," "anticipate," "outlook," "could," "target," "project," "intend," "plan," "believe," "seek," "estimate," "should," "may," "assume," "continue," variations of such words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. We describe our respective risks, uncertainties, and assumptions that could affect the outcome or results of operations in "Item 1A. Risk Factors." We have based our forward looking statements on our management's beliefs and assumptions based on information available to our management at the time the statements are made. We caution you that actual outcomes and results may differ materially from what is expressed, implied, or forecast by our forward looking statements. Reference is made in particular to forward looking statements regarding projections or estimates concerning our business, including demand for our products and services, mix of revenue streams, ability to control and/or reduce operating expenses, anticipated gross margins and operating results, cost savings, product development efforts, general outlook of our business and industry, international businesses, competitive position, adequate liquidity to fund our operations and meet our other cash requirements. Except as required under the federal securities laws and the rules and regulations of the SEC, we do not have any intention or obligation to update publicly any forward looking statements after the distribution of this report, whether as a result of new information, future events, changes in assumptions, or otherwise.

## PART I

### ITEM 1. BUSINESS

#### GENERAL

Tag-It Pacific, Inc. is an apparel company that specializes in the manufacturing and distribution of a full range of apparel accessories including zippers and trim items to manufacturers of fashion apparel, specialty retailers

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and mass merchandisers. We manufacture and distribute zippers under our TALON(R) brand name to manufacturers for apparel brands and retailers such as Levi Strauss & Co., Abercrombie & Fitch, Wal-Mart, Kohl's, The Gap and JC Penney, among others. We also provide full service outsourced trim design, sourcing and management services and supply specified trim items for manufacturers of fashion apparel such as Abercrombie & Fitch, Victoria's Secret, American Eagle, Motherhood, Express, Polo Ralph Lauren and others. Under our TEKFIT(R) brand, we develop and sell apparel components that utilize a patented technology, including a stretch waistband.

We were incorporated in the State of Delaware in 1997. We were formed to serve as the parent holding company of Tag-It, Inc., a California corporation, Tag-It Printing & Packaging Ltd., which changed its name in 1999 to Tag-It Pacific (HK) LTD, a BVI corporation, Tagit de Mexico, S.A. de C.V., A.G.S. Stationery, Inc., a California corporation, and Pacific Trim & Belt, Inc., a California corporation. All of these companies were consolidated under a parent limited liability company in October 1997. These companies became our wholly owned subsidiaries immediately prior to the effective date of our initial public offering in January 1998. In 2000, we formed two wholly owned subsidiaries of Tag-It Pacific, Inc: Tag-It Pacific Limited, a Hong Kong corporation, and Talon International, Inc., a Delaware corporation. During 2006 we formed two wholly owned subsidiaries of Tag-It Pacific, Inc.; Talon Zipper (Shenzhen) Company Ltd. in China, and Talon International Pvt. Ltd., in India. Our Web site is [WWW.TAGITPACIFIC.COM](http://WWW.TAGITPACIFIC.COM). Our Web site address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on our website is not and should not be considered part of this report and is not incorporated by reference in this document.

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### BUSINESS SUMMARY

We operate our business within three product groups, Talon, Trim, and Tekfit. In our Talon group, we design, engineer, test and distribute zippers under our TALON trademark and trade names to apparel brands and manufacturers. TALON enjoys brand recognition in the apparel industry worldwide. TALON is a 100-year-old brand, which is well known for quality and product innovation, and was the original pioneer of the formed wire metal zipper for the jeans industry and is a specified zipper brand for manufacturers in the sportswear and outerwear markets worldwide. We provide a line of high quality zippers, including a specialty zipper for kids clothing, for distribution to apparel manufacturers in Asia, Mexico and Central America and have sales and marketing teams in all of these areas. We have also developed, and are now implementing, joint manufacturing arrangements in various geographic international local markets to finish and sell zippers under the TALON brand name. Our contractors work with, purchase or install equipment locally for dying and producing finished zippers. We expect this program to significantly improve the speed at which we serve the market and to expand the geographic footprint of our TALON products. The TALON zipper is promoted both within our trim packages, as well as a stand-alone product line.

In our Trim products group, we act as a fully integrated single-source supplier, designer and sourcing agent of a full range of trim items for manufacturers of fashion apparel. Our business focuses on servicing all of the trim requirements of our customers at the manufacturing and retail brand level of the fashion apparel industry. Trim items include labels, buttons, rivets, printed marketing material, polybasic, packing cartons, and hangers. Trim items comprise a relatively small part of the cost of most apparel products but comprise the vast majority of components necessary to fabricate a typical

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apparel product. We offer customers a one-stop outsourced service for all trim related matters. Our teams work with the apparel designers, and function as an extension of their staff.

If our customer is creating a new pair of cargo pants for their fall collection, our Trim products group will collaborate with them on their design vision, then present examples of their vision in graphic form for all apparel accessory components. We will design the buttons, snaps, hang tags, labels, zippers, zipper pullers and other items. Once our customer selects the designs they like, our sourcing and production teams coordinate with our proprietary database of manufacturers worldwide to ensure the best manufacturing solution for the items being produced. The proper manufacturing and sourcing solution is a critical part of our service. Knowing the best facility or supplier to ensure timely production, the proper paper finishes, distressing or other types of material needs or manufacturing techniques to be used is critical. Because we perform this function for many different global projects and apparel brands, we have a depth and breadth of knowledge in the manufacturing and sourcing that our customers cannot achieve, and therefore offer a significant value to our customers. In addition, because we are consistently innovating new items, manufacturing techniques and finishes, we bring many new, fresh and unique ideas to our customers. Once we identify the appropriate supply source, we create production samples of all of our designs and products, and review the samples with our customers so they can make a final decision while looking at the actual items that will be used on the garments. When the customer selects the appropriate items, we are identified as the sole-source trim supplier for the project, and our customer's factories are then required to purchase the trim products from us. Throughout the garment manufacturing process, we consistently monitor the timing and accuracy of the production items to ensure the production items exactly match all samples when delivered to our customer's apparel factories.

We also serve as a specified supplier in our zipper and trim products for a variety of major retail brand and private-label oriented companies. A specified supplier is a supplier that has been approved for its quality and service by a major retail brand or private-label company. Apparel contractors manufacturing for the retail brand or private-label company must purchase their zipper and trim requirements from a supplier that has been specified. We seek to expand our services as a supplier of select items for such customers, to being a preferred or single-source provider of the entire brand customer's authorized trim and zipper requirements. Our ability to offer a full range of trim and zipper products is attractive to brand name and private-label oriented customers because it enables the customer to address their quality and supply needs for all of their trim requirements from a single source, avoiding the time and expense necessary to monitor quality and supply from multiple vendors and manufacturer sources. Becoming a specified supplier to brand

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customers gives us an advantage to become the preferred or sole vendor of trim and zipper items for all apparel manufacturers contracted for production for that brand name.

Our teams of sales employees, representatives, program managers, creative design personnel and global production and distribution coordinators at our facilities located in the United States, China, India and the Caribbean enable us to take advantage of and address the increasingly complicated requirements of the large and expanding demand for complete apparel accessory solutions. We plan to continue to expand operations in Asia, Europe, Central and South America and the Caribbean to take advantage of the large apparel

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manufacturing markets in these regions.

### PRODUCTS

TALON ZIPPERS - We offer a full line of metal and synthetic zippers bearing the TALON brand name. TALON(R) zippers are used primarily by manufacturers in the apparel industry and are distributed through our distribution facilities in the United States, India and China and through our agents, distributors and affiliates in other international markets.

We plan to expand our distribution of TALON zippers through the establishment of a network of TALON owned sales, distribution and manufacturing locations, distribution relationships and joint ventures. The network of these distributors and manufacturing joint ventures, in combination with TALON owned and affiliated facilities under the TALON brand, is expected to improve our time-to-market by eliminating the typical setup and build-out phase for new manufacturing capacity throughout the world, and by sourcing, finishing and distributing to apparel manufacturers in their local markets. The branded apparel zipper market is dominated by one company and we are positioning TALON to be a viable global alternative to this competitor and capture an increased market share position. We plan to leverage the brand awareness of the TALON name by branding other products in our line with the TALON name.

TRIM - We consider our high level of customer service as a fully integrated single-source supplier essential to our success. We combine our high level of customer service within our TRIM solutions with a history of design and manufacturing expertise to offer our customers a complete trim solution product. We believe this full-service product gives us a competitive edge over companies that only offer selected trim components because our full service solutions saves our customers substantial time in ordering, designing, sampling and managing trim orders from several different suppliers. Our proprietary tracking and order management systems allow us to seamlessly supply trim solutions and products to apparel brands, retailers and manufacturers around the world.

We produce customized woven, leather, synthetic, embroidered and novelty labels and tapes, which can be printed on or woven into a wide range of fabrics and other materials using various types of high-speed equipment. As an additional service, we may provide our customers the machinery used to attach the buttons, rivets and snaps we distribute.

In 2005 we marketed and supplied complete trim packages on a per-garment basis which we assembled on behalf of our customers. Each trim package included all items of trim that a customer needed in the manufacture of a particular item of apparel, including thread, zippers, labels, buttons, rivets, polybags, packing cartons and hangers. We also included printed marketing materials such as hang tags, bar-coded hang tags, pocket flashers, waistband tickets and size stickers that were attached to products to identify and promote the products, permit automated data collection, provide brand identification and communicate consumer information such as a product's retail price, size, fabric content and care instructions. We continue to sell the trim package components separately, but phased-out the offering as a complete kit in late 2005 as our cost of labor for the assembly was no longer competitive, and the market was not willing to pay the premium for pre-assembly of the trim material. In 2005 we also decided to discontinue offering thread as a portion of our trim products and we negotiated an agreement with our supplier for the return of substantially all of the company's thread products. We instead, are sharpening our focus on the market opportunity in which we add the most value, our full-service Trim solutions.

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TEKFIT - We distribute a proprietary stretch waistband under our Exclusive License and Intellectual Property Rights agreement with Pro-Fit Holdings, Limited. The agreement gives us the exclusive rights to sell or sublicense stretch waistbands manufactured under the patented technology developed by Pro-Fit for garments manufactured anywhere in the world for sale in the U.S. market and for all U.S. brands for the life of the patent. We offer apparel manufacturers advanced, patented fabric technologies to utilize in their garments under the TEKFIT name. This technology allows fabrics to be altered through the addition of stretch characteristics resulting in greatly improved fit and comfort. This technology allows pant manufacturers to build-in a stretch factor into standard waistbands that does not alter the appearance of the garment, but will allow the waist to stretch out and back by as much as two waist sizes. Previously, we supplied Levi Strauss & Co. with TEKFIT waistbands for their Dockers(R) programs, under an exclusive supply agreement. In October 2006 our exclusive contract with this brand expired. With the expiration of this contract we now have broader access to other customers and we intend to actively expand this product offering to other brands. Orders have already been placed by a new brand and deliveries are scheduled early in 2007. However, sales of this product to Levi are expected to end during the first quarter of 2007 and to be significantly lower than in the previous year, and orders from new brands are not expected to fully offset these declines for at least the next two quarters, if at all. Consequently, we expect sales and earnings contributions from this product line to decline significantly for at least the first half of 2007.

Our efforts to expand this product offering to other customers have also been limited by a licensing dispute. As described more fully in Item 3 "Legal Proceedings" we are presently in litigation with Pro-Fit related to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured under Pro-Fit's patented technology.

The revenues we derive from the sale of products incorporating the stretch waistband technology represented approximately 19% of our consolidated revenues for the years ended December 31, 2006 and 2005, and 25% for the year ended December 31, 2004. Accordingly, the results of operations and financial condition could be materially adversely affected if our dispute with Pro-Fit is not resolved in a manner favorable to us, or if we are unsuccessful in securing new customers to replace the revenues previously generated by our exclusive sales of this product to Levi.

### DESIGN AND DEVELOPMENT

Our in-house creative team produces products with innovative technology and designs that we believe distinguish our products from those of our competitors. We support our skills and expertise in material procurement and product-manufacturing coordination with product technology and designs intended to meet fashion demands, as well as functional and cost parameters. We recently introduced the Talon KidZip which is a specialty zipper for children's apparel engineered to surpass industry established strength and safety tests, while maintaining the fashion image and requirements of today's apparel demands.

Many specialty design companies with which we compete have limited engineering, sourcing or manufacturing experience. These companies create products or designs that often cannot be implemented due to difficulties in the manufacturing process, the expenses of required materials, or a lack of functionality in the resulting product. We design products to function within the limitations imposed by the applicable manufacturing framework. Using our manufacturing and sourcing experience, we ensure delivery of quality products and we minimize the time-consuming delays that often arise in coordinating the efforts of independent design houses and manufacturing facilities. By supporting our material procurement and product manufacturing services with design

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services, we believe that we reduce development and production costs and deliver products to our customers sooner than many of our competitors. Our development costs are low, most of which are borne by our customers. Our design teams are based out of our California and Hong Kong facilities.

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### CUSTOMERS

We have more than 500 active customers. Our customers include the designated suppliers of well-known apparel manufacturers, such as Levi Strauss & Co., Abercrombie & Fitch, Juicy Couture, Victoria's Secret, and Polo Ralph Lauren, among others. Our customers also include contractors for specialty retailers such as Express and the Gap and mass merchant retailers such as Wal-Mart, Kohl's and Target.

In 2002, we entered into an exclusive supply contract with Levi Strauss & Co. which was extended through October 2006. Under the terms of the supply agreement, Levi Strauss & Co. agreed to purchase a minimum of \$10 million of TEKFIT stretch waistbands, various other trim products, garment components and services over the term of the agreement. Levi Strauss & Co. also appointed TALON as an approved zipper supplier. In October 2006 we mutually agreed to allow this agreement to expire and to allow us to market and sell this waistband to other customers. We are currently discussing this product with, and preparing samples for several large apparel brands and retailers.

For the year ended December 31, 2006, no single customer represented more than 9% of our consolidated net sales; however our three largest customers represented approximately 18% of our consolidated net sales. For the year ended December 31, 2005, no single customer represented more than 10% of our consolidated net sales; however, our three largest customers represented approximately 22% of our consolidated net sales. Two major customers accounted for approximately 22% of our net sales for the year ended December 31, 2004.

Our results of our operations will depend to an extent upon the commercial success of these customers. If these customers fail to purchase our products at anticipated levels, or the relationship terminates, it may have an adverse affect on our results of operations. If the financial condition of these customers were to deteriorate, resulting in an impairment of their ability to purchase inventories or repay receivables, it may also have an adverse affect on our results of operations. The financial position and operations of these customers are monitored on an ongoing basis. United States export sales are not a significant part of our business. Backlogs are not considered material in the industries in which we compete.

### SALES AND MARKETING

We sell our principal products through our own sales force based in Los Angeles, California, various other cities in the United States, Hong Kong, China, India, Taiwan and the Dominican Republic. We also employ customer service representatives who are assigned to key customers and provide in-house customer service support. Our executives have developed relationships with our major customers at senior levels. These executives actively participate in marketing and sales functions and the development of our overall marketing and sales strategies. When we become the outsourcing vendor for a customer's packaging or trim requirements, we position ourselves as if we are an in-house department of the customer's trim procurement operation.

### SOURCING AND ASSEMBLY



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We have developed expertise in identifying high quality materials, competitive prices and approved vendors for particular products and materials. This expertise enables us to produce a broad range of packaging and trim products at various price points. The majority of products that we procure and distribute are purchased on a finished good basis. Raw materials, including paper products and metals used to manufacture zippers, used in the assembly of our Trim products are available from numerous sources and are in adequate supply. We purchase products from several qualified material suppliers.

We create most product artwork and any necessary dies and molds used to design and manufacture our products. All other products that we design and sell are produced by third party vendors or under our direct supervision or through joint manufacturing arrangements. We are confident in our ability to secure high quality manufacturing sources. We intend to continue to outsource production to qualified vendors, particularly with respect to manufacturing activities that require substantial investment in capital equipment.

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Principally through our Hong Kong facility, we distribute TALON zippers, trim items and apparel packaging and coordinate the manufacture and distribution of the full range of our products. Our Hong Kong facility supplies several significant trim programs, services customers located in Asia and the Pacific Rim and sources products for our Los Angeles based operations.

### INTELLECTUAL PROPERTY RIGHTS AND LICENSES

We have trademarks as well as copyrights, software copyrights and trade names for which we rely on common law protection, including the TALON trademark. Several of our other trademarks are the subject of applications for federal trademark protection through registration with the United States Patent and Trademark Office, including "Talon", "Tag-It", "Managed Trim Solution" and "TekFit". We also rely on our Exclusive License and Intellectual Property Rights agreement with Pro-Fit to sell our TEKFIT Stretch waistbands. The agreement gives us the exclusive rights to sell or sublicense stretch waistbands manufactured under the patented technology developed by Pro-Fit for garments manufactured anywhere in the world for the U.S. market and for all U.S. brands, for an indefinite term that extends for the duration of the patent and trade secrets licensed under the agreement. We are presently in litigation with Pro-Fit relating to our rights under the agreement, as described more fully elsewhere in this report.

### SEASONALITY

We typically experience seasonal fluctuations in sales volume. These seasonal fluctuations result in sales volume decreases in the first and fourth quarters of each year due to the seasonal fluctuations experienced by the majority of our customers. The apparel industry typically experiences higher sales volume in the second quarter in preparation for back-to-school purchases, and the third quarter in preparation for year-end holiday purchases.

### INVENTORIES

In order to meet the rapid delivery requirements of our customers, we may be required to purchase inventories based upon projections made by our customers. In these cases we may carry a substantial amount of inventory on their behalf. We attempt to manage this risk by obtaining customer commitments to purchase any excess inventories. These buyback arrangements provide that in

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the event that inventories remain with us in excess of six to nine months from our receipt of the goods from our vendors or the termination of production of a customer's product line related to the inventories, the customer is required to purchase the inventories from us under normal invoice and selling terms. While these agreements provide us some advantage in the negotiated disposition of these inventories, we cannot be assured that our customers will complete these agreements or that we can enforce these agreements without adversely affecting our business operations.

### COMPETITION

We compete in highly competitive and fragmented industries that include numerous local and regional companies that provide some or all of the products we offer. We also compete with United States and international design companies, distributors and manufacturers of tags, trim, packaging products and zippers. Some of our competitors, including Paxar Corporation, YKK, Universal Button, Inc., Avery Denison Corporation and Scovill Fasteners, Inc. have greater name recognition, longer operating histories and greater financial and other resources.

Because of our integrated materials procurement and assembly capabilities and our full-service trim solutions, we believe that we are able to effectively compete for our customers' business, particularly where our customers require coordination of separately sourced production functions. We believe that to successfully compete in our industry we must offer superior product pricing, quality, customer service, design capabilities, delivery lead times and complete supply-chain management. We also believe the TALON brand name and the quality of our TALON brand zippers will allow us to gain market share in the zipper industry. The

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unique stretch quality of our TEKFIT waistbands will also allow us to compete effectively in the market for waistband components.

### SEGMENT INFORMATION

We operate primarily in one industry segment, the distribution of a full range of apparel zipper and trim products to manufacturers of fashion apparel, specialty retailers and mass merchandisers.

### FINANCIAL INFORMATION ABOUT GEOGRAPHIC AREA

We sell the majority of our products for use by U.S. based brands, retailers and manufacturers. The majority of these customers produce their products or outsource the production of their products in manufacturing facilities located outside of the U.S., primarily in Asia, Mexico, the Dominican Republic and Central and South America.

A summary of our domestic and international net sales and long-lived assets is set forth in Item 8, "Notes to consolidated financial statements", Note 14. Approximately 90% of our overall net sales came from sales to U.S. based or contract manufacturers' facilities located outside of the United States during the year ended December 31, 2006.

We are subject to certain risks referred to in Item 1A, "Risk Factors" and Item 3, "Legal Proceedings", including those normally attending international and domestic operations, such as changes in economic or political conditions, currency fluctuations, foreign tax claims or assessments, exchange

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control regulations and the effect of international relations and domestic affairs of foreign countries on the conduct of business, legal proceedings, and the availability and pricing of raw materials.

### EMPLOYEES

As of December 31, 2006, we had approximately 135 full-time employees including 35 in the United States, 74 employees in Hong Kong, 24 employees in China and 2 in Taiwan. Our labor forces are non-union. We believe that we have satisfactory employee and labor relations.

### CORPORATE GOVERNANCE AND INFORMATION RELATED TO SEC FILINGS

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed with, or furnished to, the Securities and Exchange Commission ("SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge through our Web site, [WWW.TAGITPACIFIC.COM](http://WWW.TAGITPACIFIC.COM) (in the "Investor Relations" section, as soon as reasonably practical after electronic filing with or furnishing of such material to the SEC) We make available at the Web site our (i) shareholder communications policies, (ii) Code of Ethical Conduct, (iii) the charters of the Audit and Nominating Committees of our Board of Directors, and (iv) Employee Complaint Procedures for Accounting and Auditing Matters. These materials are also available free of charge in print to stockholders who request them by writing to: Investor Relations, Tag-It Pacific, Inc., 21900 Burbank Boulevard, Suite 270, Woodland Hills, CA 91367. Our Web site address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on our website is not and should not be considered part of this report and is not incorporated by reference in this document.

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### ITEM 1A. RISK FACTORS

Several of the matters discussed in this document contain forward-looking statements that involve risks and uncertainties. Factors associated with the forward-looking statements that could cause actual results to differ from those projected or forecast are included in the statements below. In addition to other information contained in this report, readers should carefully consider the following cautionary statements and risk factors.

OUR GROWTH AND OPERATING RESULTS COULD BE MATERIALLY, ADVERSELY AFFECTED IF WE ARE UNSUCCESSFUL IN RESOLVING A DISPUTE THAT NOW EXISTS REGARDING OUR RIGHTS UNDER OUR EXCLUSIVE LICENSE AND INTELLECTUAL PROPERTY AGREEMENT WITH PRO-FIT. Pursuant to our agreement with Pro-Fit Holdings, Limited, we have exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. We are in litigation with Pro-Fit regarding our rights. See Item 3, "Legal Proceedings" for discussion of this litigation. We derive a significant amount of revenues from the sale of products incorporating the stretch waistband technology. Our business, results of operations and financial condition could be materially adversely affected if we are unable to reach a settlement in a manner acceptable to us and ensuing litigation 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.

IF WE LOSE OUR LARGER CUSTOMERS OR THEY FAIL TO PURCHASE AT ANTICIPATED LEVELS, OUR SALES AND OPERATING RESULTS WILL BE ADVERSELY AFFECTED. Our results

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of operations will depend to a significant extent upon the commercial success of our larger customers. If these customers fail to purchase our products at anticipated levels, or our relationship with these customers terminates, it may have an adverse affect on our results because:

- o We will lose a primary source of revenue if these customers choose not to purchase our products or services;
- o We may not be able to reduce fixed costs incurred in developing the relationship with these customers in a timely manner;
- o We may not be able to recoup setup and inventory costs;
- o We may be left holding inventory that cannot be sold to other customers; and
- o We may not be able to collect our receivables from them.

In October 2006, our exclusive supply agreement with Levi Strauss & Co., pursuant to which we supplied Levi with TEKFIT waistbands for their Dockers programs, expired. With the expiration of this contract we now have broader access to other customers and we intend to actively expand this product offering to other brands. While some orders have already been placed by a new brand and deliveries are scheduled early in 2007, sales of this product to Levi are expected to end during the first quarter of 2007 and to be significantly lower than in the previous year, and orders from new brands are not expected to fully offset these declines for at least the next two quarters, if at all. The revenues we derived from the sale of products incorporating the stretch waistband technology represented approximately 19% of our consolidated revenues for the years ended December 31, 2005 and 2006. A failure to attract new customers for our TEKFIT waistbands could have a material adverse effect on our sales and results of operations.

IF WE ARE NOT ABLE TO REGAIN COMPLIANCE WITH LISTING REQUIREMENTS, OUR SHARES MAY BE REMOVED FROM LISTING ON AMEX. In May 2006 we were advised by AMEX that we were non-compliant with the minimum net equity listing requirements and we were afforded an opportunity to submit a plan to AMEX that provided for increases in our equity beyond the minimum \$4.0 million equity requirement within an eighteen-month timeframe from the date of the notice from AMEX. On August 3, 2006 AMEX accepted our plan to regain compliance and has given us an extension until November 16, 2007 to become compliant with the AMEX continued listing standards. During this period, we 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. In addition we have

suffered substantial recurring losses and may fail to comply with other listing requirements of AMEX. We may not be able to regain compliance with these matters within the time allowed by the exchange, and our shares of common stock may be removed from the listing on AMEX.

IF WE ARE NOT ABLE TO RESTRUCTURE THE \$12.5 MILLION SECURED CONVERTIBLE PROMISSORY NOTES PAYABLE TO EXTEND THE MATURITY OF THIS DEBT, OR TO SECURE ALTERNATE FINANCING TO REPLACE THESE NOTES, WE MAY DEFAULT ON THEIR PAYMENT. The \$12.5 million in convertible notes payable mature in November 2007 and it is

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more likely than not that we will not be able to generate sufficient cash flow from operations in time to pay these notes. The debt holders have a conversion option at \$3.65 per share and we can require conversion only if the market price of our stock exceeds 120% of the conversion price for a minimum of fifteen trading days just prior to their maturity and certain trading volume requirements are met. In the event that the shares are not converted, in order to obtain an extension of the note term we may have to lower the conversion price of the debt resulting in additional dilution of the current shareholder value, or we may default on their payment and the note holders, in addition to pursuing other remedies, may take action to secure the collateral for these notes, the TALON brand name, resulting in substantial disruption to our business operations and adversely affecting the financial operating results and financial position of the company going forward.

IF CUSTOMERS DEFAULT ON INVENTORY PURCHASE COMMITMENTS WITH US, WE WILL BE LEFT HOLDING NON-SALABLE INVENTORY. We hold significant inventories for specific customer programs, which the customers have committed to purchase. If any customer defaults on these commitments, or insists on markdowns, we may incur a charge in connection with our holding significant amounts of non-salable inventory and this would have a negative impact on our operations and cash flow.

OUR REVENUES MAY BE HARMED IF GENERAL ECONOMIC CONDITIONS WORSEN. Our revenues depend on the health of the economy and the growth of our customers and potential future customers. When economic conditions weaken, certain apparel manufacturers and retailers, including some of our customers may experience financial difficulties that increase the risk of extending credit to such customers. Customers adversely affected by economic conditions have also attempted to improve their own operating efficiencies by concentrating their purchasing power among a narrowing group of vendors. There can be no assurance that we will remain a preferred vendor to our existing customers. A decrease in business from or loss of a major customer could have a material adverse effect on our results of operations. Further, if the economic conditions in the United States worsen or if a wider or global economic slowdown occurs, we may experience a material adverse impact on our business, operating results, and financial condition.

BECAUSE WE DEPEND ON A LIMITED NUMBER OF SUPPLIERS, WE MAY NOT BE ABLE TO ALWAYS OBTAIN MATERIALS WHEN WE NEED THEM AND WE MAY LOSE SALES AND CUSTOMERS. Lead times for materials we order can vary significantly and depend on many factors, including the specific supplier, the contract terms and the demand for particular materials at a given time. From time to time, we may experience fluctuations in the prices, and disruptions in the supply, of materials. Shortages or disruptions in the supply of materials, or our inability to procure materials from alternate sources at acceptable prices in a timely manner, could lead us to miss deadlines for orders and lose sales and customers.

WE OPERATE IN AN INDUSTRY THAT IS SUBJECT TO SIGNIFICANT FLUCTUATIONS IN OPERATING RESULTS THAT MAY RESULT IN UNEXPECTED REDUCTIONS IN REVENUE AND STOCK PRICE VOLATILITY. We operate in an industry that is subject to significant fluctuations in operating results from quarter to quarter, which may lead to unexpected reductions in revenues and stock price volatility. Factors that may influence our quarterly operating results include:

- o The volume and timing of customer orders received during the quarter;
- o The timing and magnitude of customers' marketing campaigns;
- o The loss or addition of a major customer;
- o The availability and pricing of materials for our products;

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- o The increased expenses incurred in connection with the introduction of new products;

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- o Currency fluctuations;
- o Delays caused by third parties; and
- o Changes in our product mix or in the relative contribution to sales of our subsidiaries.

Due to these factors, it is possible that in some quarters our operating results may be below our stockholders' expectations and those of public market analysts. If this occurs, the price of our common stock could be adversely affected. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against such a company. In October 2005, a securities class action lawsuit was filed against us. See Item 3, "Legal Proceedings" for a detailed description of this lawsuit.

THE OUTCOME OF LITIGATION IN WHICH WE HAVE BEEN NAMED AS A DEFENDANT IS UNPREDICTABLE AND AN ADVERSE DECISION IN ANY SUCH MATTER COULD HAVE A MATERIAL ADVERSE AFFECT ON OUR FINANCIAL POSITION AND RESULTS OF OPERATIONS. We are defendants in a number of litigation matters. These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made in each and all of the litigation matters to which we have been named a party, and intend to contest each lawsuit vigorously, no assurances can be given that the results of these matters will be favorable to us. An adverse resolution of any of these lawsuits could have a material adverse affect on our financial position and results of operations.

We maintain product liability and director and officer insurance that we regard as reasonably adequate to protect us from potential claims; however we cannot assure you that it will be adequate to cover any losses. Further, the costs of insurance have increased dramatically in recent years, and the availability of coverage has decreased. As a result, we cannot assure you that we will be able to maintain our current levels of insurance at a reasonable cost, or at all.

OUR CUSTOMERS HAVE CYCLICAL BUYING PATTERNS WHICH MAY CAUSE US TO HAVE PERIODS OF LOW SALES VOLUME. Most of our customers are in the apparel industry. The apparel industry historically has been subject to substantial cyclical variations. Our business has experienced, and we expect our business to continue to experience, significant cyclical fluctuations due, in part, to customer buying patterns, which may result in periods of low sales usually in the first and fourth quarters of our financial year.

OUR BUSINESS MODEL IS DEPENDENT ON INTEGRATION OF INFORMATION SYSTEMS ON A GLOBAL BASIS AND, TO THE EXTENT THAT WE FAIL TO MAINTAIN AND SUPPORT OUR INFORMATION SYSTEMS, IT CAN RESULT IN LOST REVENUES. We must consolidate and centralize the management of our subsidiaries and significantly expand and improve our financial and operating controls. Additionally, we must effectively integrate the information systems of our worldwide operations with the information systems of our principal offices in California. Our failure to do so could result in lost revenues, delay financial reporting or adverse effects on the information reported.

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THE LOSS OF KEY MANAGEMENT AND SALES PERSONNEL COULD ADVERSELY AFFECT OUR BUSINESS, INCLUDING OUR ABILITY TO OBTAIN AND SECURE ACCOUNTS AND GENERATE SALES. Our success has and will continue to depend to a significant extent upon key management and sales personnel, many of whom would be difficult to replace. The loss of the services of key employees could have a material adverse effect on our business, including our ability to establish and maintain client relationships. Our future success will depend in large part upon our ability to attract and retain personnel with a variety of sales, operating and managerial skills.

IF WE EXPERIENCE DISRUPTIONS AT ANY OF OUR FOREIGN FACILITIES, WE WILL NOT BE ABLE TO MEET OUR OBLIGATIONS AND MAY LOSE SALES AND CUSTOMERS. Currently, we do not operate duplicate facilities in different geographic areas. Therefore, in the event of a regional disruption where we maintain one or more of our facilities, it is unlikely that we could shift our operations to a different geographic region and we may have to cease or curtail our operations. This may cause us to lose sales and customers. The types of disruptions that may occur include:

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- o Foreign trade disruptions;
- o Import restrictions;
- o Labor disruptions;
- o Embargoes;
- o Government intervention;
- o Natural disasters; or
- o Regional pandemics.

INTERNET-BASED SYSTEMS THAT WE RELY UPON FOR OUR ORDER TRACKING AND MANAGEMENT SYSTEMS MAY EXPERIENCE DISRUPTIONS AND AS A RESULT WE MAY LOSE REVENUES AND CUSTOMERS. To the extent that we fail to adequately update and maintain the hardware and software implementing our integrated systems, our customers may be delayed or interrupted due to defects in our hardware or our source code. In addition, since our software is Internet-based, interruptions in Internet service generally can negatively impact our ability to use our systems to monitor and manage various aspects of our customer's trim needs. Such defects or interruptions could result in lost revenues and lost customers.

THERE ARE MANY COMPANIES THAT OFFER SOME OR ALL OF THE PRODUCTS AND SERVICES WE SELL AND IF WE ARE UNABLE TO SUCCESSFULLY COMPETE OUR BUSINESS WILL BE ADVERSELY AFFECTED. We compete in highly competitive and fragmented industries with numerous local and regional companies that provide some or all of the products and services we offer. We compete with national and international design companies, distributors and manufacturers of tags, packaging products, zippers and other trim items. Some of our competitors have greater name recognition, longer operating histories and greater financial and other resources than we do.

UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY MAY INCREASE OUR LITIGATION COSTS AND ADVERSELY AFFECT OUR SALES. We rely on trademark, trade secret and copyright laws to protect our designs and other proprietary property worldwide. We cannot be certain that these laws will be sufficient to protect

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our property. In particular, the laws of some countries in which our products are distributed or may be distributed in the future may not protect our products and intellectual rights to the same extent as the laws of the United States. If litigation is necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others, such litigation could result in substantial costs and diversion of resources. This could have a material adverse effect on our operating results and financial condition. Ultimately, we may be unable, for financial or other reasons, to enforce our rights under intellectual property laws, which could result in lost sales.

IF OUR PRODUCTS INFRINGE ANY OTHER PERSON'S PROPRIETARY RIGHTS, WE MAY BE SUED AND HAVE TO PAY LEGAL EXPENSES AND JUDGMENTS AND REDESIGN OR DISCONTINUE SELLING OUR PRODUCTS. From time to time in our industry, third parties allege infringement of their proprietary rights. Any infringement claims, whether or not meritorious, could result in costly litigation or require us to enter into royalty or licensing agreements as a means of settlement. If we are found to have infringed the proprietary rights of others, we could be required to pay damages, cease sales of the infringing products and redesign the products or discontinue their sale. Any of these outcomes, individually or collectively, could have a material adverse effect on our operating results and financial condition.

COUNTERFEIT PRODUCTS ARE NOT UNCOMMON IN THE APPAREL INDUSTRY AND OUR CUSTOMERS MAY MAKE CLAIMS AGAINST US FOR PRODUCTS WE HAVE NOT PRODUCED AND WE MAY BE ADVERSELY IMPACTED BY THESE FALSE CLAIMS. Counterfeiting of valuable trade names is commonplace in the apparel industry and while there are industry organizations and federal laws designed to protect the brand owner, these counterfeit products are not always detected and it can be difficult to prove the manufacturing source of these products. Accordingly, we may be adversely affected if counterfeit products damage our relationships with customers, and we incur costs to prove these products are counterfeit, to defend ourselves against false claims, or we may have to pay for false claims.

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OUR STOCK PRICE MAY DECREASE, WHICH COULD ADVERSELY AFFECT OUR BUSINESS AND CAUSE OUR STOCKHOLDERS TO SUFFER SIGNIFICANT LOSSES. The following factors could cause the market price of our common stock to decrease, perhaps substantially:

- o The failure of our quarterly operating results to meet expectations of investors or securities analysts;
- o Adverse developments in the financial markets, the apparel industry and the worldwide or regional economies;
- o Interest rates;
- o Changes in accounting principles;
- o Intellectual property and legal matters;
- o Sales of common stock by existing shareholders or holders of options;
- o Announcements of key developments by our competitors; and
- o The reaction of markets and securities analysts to



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announcements and developments involving our company.

IF WE NEED TO SELL OR ISSUE ADDITIONAL SHARES OF COMMON STOCK OR ASSUME ADDITIONAL DEBT TO FINANCE FUTURE GROWTH, OUR STOCKHOLDERS' OWNERSHIP COULD BE DILUTED OR OUR EARNINGS COULD BE ADVERSELY IMPACTED. Our business strategy may include expansion through internal growth, by acquiring complementary businesses or by establishing strategic relationships with targeted customers and suppliers. In order to do so or to fund our other activities, we may issue additional equity securities that could dilute our stockholders' value. We may also assume additional debt and incur impairment losses to our intangible assets if we acquire another company.

WE MAY NOT BE ABLE TO REALIZE THE ANTICIPATED BENEFITS OF ACQUISITIONS. We may consider strategic acquisitions as opportunities arise, subject to the obtaining of any necessary financing. Acquisitions involve numerous risks, including diversion of our management's attention away from our operating activities. We cannot assure you that we will not encounter unanticipated problems or liabilities relating to the integration of an acquired company's operations, nor can we assure you that we will realize the anticipated benefits of any future acquisitions.

OUR ACTUAL TAX LIABILITIES MAY DIFFER FROM ESTIMATED TAX RESULTING IN UNFAVORABLE ADJUSTMENTS TO OUR FUTURE RESULTS. The amount of income taxes we pay is subject to ongoing audits by federal, state and foreign tax authorities. Our estimate of the potential outcome of uncertain tax issues is subject to our assessment of relevant risks, facts, and circumstances existing at that time. Our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, which may impact our effective tax rate and our financial results.

WE HAVE ADOPTED A NUMBER OF ANTI-TAKEOVER MEASURES THAT MAY DEPRESS THE PRICE OF OUR COMMON STOCK. Our stockholders' rights plan, our ability to issue additional shares of preferred stock and some provisions of our certificate of incorporation and bylaws and of Delaware law could make it more difficult for a third party to make an unsolicited takeover attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price.

INSIDERS OWN A SIGNIFICANT PORTION OF OUR COMMON STOCK, WHICH COULD LIMIT OUR STOCKHOLDERS' ABILITY TO INFLUENCE THE OUTCOME OF KEY TRANSACTIONS. As of April 10, 2007, our officers and directors and their affiliates beneficially owned approximately 20% of the outstanding shares of our common stock. The Dyne family, which includes Mark Dyne, Colin Dyne, and Jonathan Burstein, who are also our directors; Larry Dyne and the estate of Harold Dyne; beneficially owned approximately 15% of the outstanding shares of our common stock at March 31, 2007. As a result, our officers and directors and the Dyne family are able to exert considerable influence over the outcome of any matters submitted to a vote of the holders of our common stock, including the election of our Board of Directors. The voting power of these stockholders could also

discourage others from seeking to acquire control of us through the purchase of our common stock, which might depress the price of our common stock.

WE MAY FACE INTERRUPTION OF PRODUCTION AND SERVICES DUE TO INCREASED SECURITY MEASURES IN RESPONSE TO TERRORISM. Our business depends on the free flow of products and services through the channels of commerce. In response to

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terrorists' activities and threats aimed at the United States, transportation, mail, financial and other services may be slowed or stopped altogether. Extensive delays or stoppages in transportation, mail, financial or other services could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may experience an increase in operating costs, such as costs for transportation, insurance and security as a result of the activities and potential delays. We may also experience delays in receiving payments from payers that have been affected by the terrorist activities. The United States economy in general may be adversely affected by the terrorist activities and any economic downturn could adversely impact our results of operations, impair our ability to raise capital or otherwise adversely affect our ability to grow our business.

### ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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### ITEM 2. PROPERTIES

Our headquarters are located in the greater Los Angeles area, in Woodland Hills, California, where we lease approximately 8,800 square feet of administrative and product development space. In addition to the Woodland Hills facility, we lease 675 square feet of office space in Columbus, Ohio; 21,000 square feet of office and warehouse space in Kwun Tong, Hong Kong; 6,000 square feet of office and showroom space in Shenzhen, China; and 4,100 square feet of warehouse space in Santiago, Dominican Republic. The lease agreements related to these properties expire at various dates through September 2010. We also own a building with 41,650 square feet of manufacturing and warehouse space in Kings Mountain, North Carolina, which is being held for sale. We believe our existing facilities are adequate to meet our needs for the foreseeable future.

### ITEM 3. LEGAL PROCEEDINGS

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 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

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judgment and class certification rulings. We believe that this matter will be resolved in trial or in settlement within the limits of our 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 the lawsuit could potentially have a material adverse effect on our financial position and results of operations.

On April 16, 2004 we 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 our 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 our motion for partial summary judgment holding that summary adjudication that we did not breach our

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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 have derived a significant amount of revenue from the sale of products incorporating the stretch waistband technology, and 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.

We have agreements with our 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 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.

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We believe that our 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, we filed a procedural opposition to the claim and submitted documents to the Mexican Tax Authority in opposition to this claim, supporting our 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 we conducted our 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. We believe that any such claim is defective on both procedural and documentary grounds and does not believe there will be a material adverse affect on us.

We currently have 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.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter of 2006.

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## PART II

#### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

##### COMMON STOCK

Tag-It Pacific's Common Stock is traded on the American Stock Exchange under the symbol "TAG." The following table sets forth the high and low sales prices for the Common Stock as reported by the American Stock Exchange.

	HIGH	LOW
	-----	-----
YEAR ENDED DECEMBER 31, 2006		
1st Quarter.....	\$ 0.84	\$ 0.33
2nd Quarter.....	0.81	0.38
3rd Quarter.....	1.38	0.63
4th Quarter.....	1.35	0.72
YEAR ENDED DECEMBER 31, 2005		
1st Quarter.....	\$ 5.45	\$ 4.24
2nd Quarter.....	4.10	2.11
3rd Quarter.....	2.11	0.79
4th Quarter.....	0.89	0.29

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On March 22, 2007, the closing sales price of our Common Stock as reported on the American Stock Exchange was \$1.88 per share. As of March 22, 2007, there were 1,964 record holders of our Common Stock.

### DIVIDENDS

We have never paid dividends on our Common Stock. We are restricted from paying dividends under our Secured Convertible Promissory Notes until such notes are fully paid or converted to Common Stock. It is our intention to retain future earnings for use in our business.

### PERFORMANCE GRAPH

The following graph sets forth the percentage change in cumulative total stockholder return of our common stock during the period from December 31, 2001 to December 31, 2006, compared with the cumulative returns of the American Stock Exchange Market Value (U.S. & Foreign) Index and The Dow Jones US Clothing & Accessories Index. The comparison assumes \$100 was invested on December 31, 2001 in our common stock and in each of the foregoing indices. The stock price performance on the following graph is not necessarily indicative of future stock price performance.

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[PERFORMANCE GRAPH OMITTED]

	Cumulative Total Return					
	12/01	12/02	12/03	12/04	12/05	12/06
-----	-----	-----	-----	-----	-----	-----
TAG-IT PACIFIC, INC .....	100.00	91.90	113.67	113.92	9.11	26.08
AMEX COMPOSITE .....	100.00	100.08	144.57	178.46	220.35	262.17
DOW JONES US CLOTHING & ACCESSORIES .....	100.00	101.10	126.45	149.40	156.02	193.39

The information under this "Performance Graph" subheading shall not be deemed to be "filed" for the purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liabilities of such section, nor shall such information or exhibit be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Exchange Act, except as shall be expressly set forth by specific reference in such a filing.

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### ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data is not necessarily indicative of our future financial position or results of future operations, and should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes thereto included in Item 8, "Financial Statements and Supplementary Data" of this Report on Form 10-K.

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	YEARS ENDED DECEMBER 31, (IN THOUSANDS EXCEPT PER SHARE DATA)			
	2002	2003(1)	2004(1,2)	2005(1)
<b>CONSOLIDATED STATEMENT OF OPERATIONS DATA:</b>				
Total revenue .....	\$ 60,073	\$ 64,443	\$ 55,109	\$ 47,331
Income (loss) from operations .....	\$ 3,044	\$ (5,881)	\$ (14,527)	\$ (27,409)
Net income (loss) .....	\$ 1,496	\$ (4,745)	\$ (17,609)	\$ (29,538)
Net income (loss) per share - basic .....	\$ 0.14	\$ (0.46)	\$ (1.02)	\$ (1.62)
Net income (loss) per share - diluted .....	\$ 0.14	\$ (0.46)	\$ (1.02)	\$ (1.62)
Weighted average shares outstanding - basic .....	9,232	10,651	17,316	18,226
Weighted average shares outstanding - diluted .....	9,531	10,651	17,316	18,226
<b>CONSOLIDATED BALANCE SHEET DATA:</b>				
Cash and cash equivalents .....	\$ 285	\$ 14,443	\$ 5,461	\$ 2,277
Total assets .....	\$ 54,055	\$ 67,770	\$ 56,448	\$ 30,321
Capital lease obligations, line of credit and notes payable .....	\$ 21,263	\$ 11,759	\$ 18,792	\$ 16,001
Convertible redeemable preferred stock .....	\$ 2,895	\$ 2,895	\$ --	\$ --
Stockholders' equity .....	\$ 18,467	\$ 43,564	\$ 30,195	\$ 912
Total liabilities and stockholders' equity .....	\$ 54,055	\$ 67,770	\$ 56,448	\$ 30,321
<b>PER SHARE DATA:</b>				
Net book value per common share .....	\$ 1.98	\$ 3.79	\$ 1.66	\$ 0.05
Common shares outstanding .....	9,320	11,508	18,171	18,241

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- (1) We incurred restructuring costs of \$6.4 million, \$4 million, and \$7.7 million during the years ended December 31, 2005, 2004 and 2003, respectively.
  - (2) We incurred net charges of \$4.3 million from the write-off of obligations due from a former major customer and other fourth quarter adjustments totaling \$9.5 million during the year ended December 31, 2004.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The following management's discussion and analysis is intended to assist the reader in understanding our consolidated financial statements. This discussion is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and accompanying notes.

Tag-It Pacific, Inc. designs, sells, manufactures and distributes apparel zippers, specialty waistbands and various apparel trim products to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We sell and market these products under various branded names including TALON and

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TEKFIT. We operate the business globally under three product groups.

We plan to increase our global expansion of TALON zippers through the establishment of a network of Talon owned sales, distribution and manufacturing locations, distribution relationships and joint ventures. The network of these distributors and manufacturing joint ventures, in combination with TALON owned and affiliated facilities under the TALON brand, is expected to improve our time-to-market by eliminating the typical setup and build-out phase for new manufacturing capacity throughout the world, and by sourcing, finishing and distributing to apparel manufacturers in their local markets.

We have structured our trim business to focus as an outsourced product development, sourcing and sampling department for the most demanding brands and retailers. We believe that trim design differentiation among brands and retailers has become a critical marketing tool for our customers. By assisting our customers in the design, development, sampling and sourcing of trim, we expect to achieve higher margins for our trim products, create long-term relationships with our customers, grow our sales to a particular customer by supplying trim for a larger proportion of their brands, and better differentiate our trim sales and services from those of our competitors. We plan to aggressively expand our trim business globally, so we may better serve our apparel factory customers in the field, in addition to our brand and retail customer. We believe we can lead the industry in trim sourcing by having both an intimate relationship with our brand and retail customers, and having a distributed service organization to serve our factory customers (those that manufacture for the apparel brand and retailers) globally.

Our TEKFIT services provide manufacturers with the patented technology, manufacturing know-how and materials required to produce pants incorporating an expandable waistband. These products were previously produced by several manufacturers for one single brand. In October 2006 our exclusive supply contract with this brand expired. With the expiration of this exclusive contract we now have broader access to other customers and we intend to actively expand this product offering to other brands. Orders have already been placed by a new brand customer in October 2006 as a result of these efforts. However sales to the previous brand are expected to decline significantly in 2007 and orders from new brands are not expected to fully offset these declines in the near term. Consequently, we expect sales and earnings contributions from this product line to decline significantly for at least the first half of 2007; though we believe our sales of this product will grow subsequently as we market our products to new customers throughout the year.

Our efforts to expand this product offering to other customers have also been limited by a licensing dispute. As described more fully in this report under Item 3. "Legal Proceedings", we are presently in litigation with Pro-Fit Holdings Limited related to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured under Pro-Fit's patented technology.

The revenues we derive from the sale of products incorporating the stretch waistband technology, represented approximately 19% of our consolidated revenues for the years ended December 31, 2006 and 2005, and 25% in 2004; accordingly the results of operations and financial condition could be materially adversely affected if our dispute with Pro-Fit is not resolved in a manner favorable to us, or if we are unsuccessful in securing new customers to replace the revenues previously generated by the single brand.

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with its future growth opportunities, in August 2005 our Board of Directors adopted a restructuring plan that was substantially completed by December 31, 2005. The plan included restructuring our global operations by eliminating redundancies in our Hong Kong operation, closing our facilities in Mexico, and closing our North Carolina manufacturing facility. We have also refocused our sales efforts on higher margin products, which may result in lower net sales initially as we focus on acquiring high quality customers, and decrease our customer concentration. As a result of this restructuring, we now operate with fewer employees and will have lower associated operating and distribution expenses.

During 2005, we recorded charges in connection with this restructuring plan in accordance with SFAS No. 146 (as amended), "Accounting for Costs Associated with Exit or Disposal Activities." In addition, the restructuring plan resulted in the carrying value of certain long-lived assets, primarily equipment, being impaired. Accordingly, in 2005 we 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."

Our North Carolina manufacturing facility has been classified as "Fixed assets held for sale" in our consolidated financial statements. Management has committed to sell the asset and has listed the property for sale with a commercial real estate agent. We believe the sale of the asset is probable and that 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 assets held for sale since management intends to re-deploy this equipment in the manufacture of TALON zippers through investment or sale of this equipment to distributors of TALON zippers. This equipment is separately identified as idle equipment as a component of "Property and Equipment". See "Notes to consolidated financial statements," Note 1.

Restructuring costs recorded in the third quarter of 2005 were \$6.2 million. Additional restructuring costs of \$0.2 million were incurred in the fourth quarter of 2005. Total restructuring costs in 2005 were \$6.4 million. These costs include \$3.4 million of inventory write-downs charged to cost of goods sold; \$2.2 million for the impairment of long-lived assets (primarily machinery and equipment), \$0.2 million of one-time employee termination benefits and other costs of \$0.2 million which were charged to operating expenses. In addition, an impairment charge to goodwill of \$0.4 million was recorded. This goodwill was associated with an acquisition made to benefit our Central and South American operations. Since these operations were closed during 2005, the goodwill was impaired and written off. During the first quarter of 2004, we incurred and recorded residual restructuring charges of \$0.4 million from a restructuring plan implemented in 2003.

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. In addition to this \$4.3 million write-down in 2004, we also recorded an accounts receivable reserve of \$5.0 million (or 9.1% of net sales) in the fourth quarter of 2004 based on management's estimate of the collectibility of accounts receivable primarily related to two other customers.

Our bad debt expense for the year ended December 31, 2005 includes reserves of \$3.6 million recorded in the second quarter of 2005 based on management's estimate at the time of the collectibility of accounts receivable from one customer. The fourth quarter of 2005 includes charges of \$0.6 million representing the present value discount of a subsequent note received in 2006 in



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exchange for that same customer's accounts receivable.

In connection with our 2005 restructuring plan, we recorded an inventory write-down of \$3.4 million in the third quarter of 2005. During the fourth quarter of 2004, we recorded inventory write-downs totaling \$2.7 million based on management's estimate of the net realizable value of certain inventories.

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In 2004, we incurred net operating losses and increased our valuation allowance for deferred tax assets to reduce our net deferred tax asset from \$2.8 million to \$1.0 million. The decrease in the net deferred tax asset resulted in a charge of \$1.8 million against the provision for income taxes in the fourth quarter of 2004. In 2005, we further reduced the net carrying value of the deferred tax asset to zero, resulting in an addition to the provision for income taxes of \$1.0 million for the year ended December 31, 2005.

### RESULTS OF OPERATIONS

#### NET SALES

For the years ended December 31, 2006, 2005, and 2004, total sales by geographic region based on customer delivery locations were as follows (amounts in thousands):

	2006	CHANGE	2005	CHANGE	2004
	-----	-----	-----	-----	-----
United States .....	\$ 5,287	(41)%	\$ 8,903	85 %	\$ 4,823
Asia .....	28,975	45	20,005	57	12,786
Mexico .....	2,476	(71)	8,526	(60)	21,453
Dominican Republic ..	9,138	54	5,915	(39)	9,678
Other .....	2,949	(26)	3,982	(38)	6,369
	-----	-----	-----	-----	-----
Total .....	\$ 48,825	3 %	\$ 47,331	(14)%	\$ 55,109
	=====	=====	=====	=====	=====

Sales are influenced by a number of factors, including demand, pricing strategies, foreign exchange effects, new product launches and indications, competitive products, product supply, and acquisitions. See Item 1 "Business" for a discussion of our principal products.

Sales in 2006 increased modestly from 2005 as a net result of a substantial decline within selected markets offset by large increases in other geographical markets. Sales, principally of Trim products, to customers in Mexico declined sharply in 2006 from 2005 as the industry shift of apparel production from Latin America to Asia continued from 2005, from the discontinuance of approximately \$4.0 million in sales of products from 2005, and as we completed the closure of our assembly and distribution operations within Mexico. Sales of Trim and TALON products to customers within the U.S. also declined significantly as a result of the industry shift of apparel production and as a result of our closure of our manufacturing facility in North Carolina during the third quarter of 2005. The decline of apparel production and our sales in the North and Central American regions was substantially offset by the shifting of this production to manufacturers within Asia, and our expansion of operations with customers in this region. Additionally, expanded demand by our exclusive customer for the TEKFIT waistband also resulted in a substantial increase in our sales to the Dominican Republic, where the principal manufacturers of this product are located. Sales within Other geographical

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regions also reflect the worldwide shifting of apparel production to Asia.

The net decrease of sales in 2005 was primarily due to a decrease in sales to our customers in Mexico of trim products and, to a lesser extent, TALON zippers, resulting from the industry shift of apparel production from Latin America to Asia. Sales in Asia of our trim products and TALON zippers increased significantly during 2005. We responded to these market changes in 2005 with the implementation of a restructuring plan that included reducing our operations in Mexico and focusing our efforts on the market in Asia. Sales of our TEKFIT waistband decreased in 2005 because of lower demand from our exclusive customer for this product. During 2005, we continued our plan to decrease reliance on two significant customers in Mexico. These two customers contributed approximately \$7.7 million or 16.3% of revenues for the year ended December 31, 2005.

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### COST OF GOODS SOLD AND SELECTED OPERATING EXPENSES

The following table summarizes cost of goods sold and selected operating expenses for the years ended December 31, 2006, 2005, and 2004 (amounts in thousands):

	2006	CHANGE	2005	CHANGE	2004
Sales .....	\$48,825	3%	\$47,331	(14)%	\$55,109
Cost of goods sold .....	34,356	(27)%	47,070	5%	44,814
% of sales .....	70%	99%	81%		
Selling expenses .....	2,778	(5)%	2,929	1%	2,899
% of sales .....	6%	6%	5%		
General and administrative expense .....	10,670	(52)%	22,267	4%	21,509
% of sales .....	22%	47%	39%		
Restructuring charges .....	0	(100)%	2,474	496%	415
% of sales .....	0%		5%		1%

### COST OF GOODS SOLD

Cost of goods sold for the year ended December 31, 2006 declined 27% from 2005 as the result of a number of the actions we implemented in connection with our 2005 restructuring plan, and as a result of our focus on higher margin product sales and continued efforts to reduce costs worldwide. Cost of goods sold in 2006 declined by approximately \$4.8 million (10.3%) from 2005 as a result of higher direct margins on products sold; by approximately \$1.9 million (4.0%) from lower freight & duty charges; by a reduction in inventory adjustments and obsolescence of \$1.6 million (3.5%); by the elimination of \$3.4 million (7.3%) in restructuring charges incurred in 2005; and by approximately \$1.8 million (3.8%) from reductions in manufacturing and overhead charges; offset by increases of approximately \$0.8 million (1.8%) on higher sales volumes.

Cost of goods sold increased 5% for the year ended December 31, 2005

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primarily due to a \$3.4 million (7.7%) write-down of inventory in connection with the 2005 restructuring plan, and an increase in our inventory obsolescence reserve of \$2.1 million (4.7%), including \$0.5 million in the fourth quarter of 2005. Cost of sales also increased as a percentage of sales due to unabsorbed overhead costs incurred in our North Carolina manufacturing facility and charges of approximately \$0.2 million (0.5%) associated with unrealized charge-backs recorded in the second quarter of 2005 and \$0.6 million (1.3%) in credits issued to customers during the first quarter for defective products received from a major supplier. Cost of goods sold declined by approximately \$4.1 million (9.1%) as a result of the decline in revenue from 2004 to 2005.

Cost of goods sold for the year ended December 31, 2004, included inventory write-downs totaling \$2.7 million (5% of net sales) recorded in the fourth quarter of 2004 based on management's estimate of the net realizable value of certain inventory.

### SELLING EXPENSES

Selling expense for the year ended December 31, 2006 decreased \$0.2 million (5.0%) from 2005 as a result of lower travel and entertainment costs of \$0.3 million; lower legal costs of \$0.3 million; and other employee benefit and administrative cost reductions of approximately \$0.1 million; offset by increases in sales commissions of approximately \$0.3 million and increased spending for sales and marketing programs of \$0.2 million. Selling expenses increased 1.0% for the year ended December 31, 2005 because we were unable to reduce expenses in direct proportion to the decrease in sales. In 2004, selling expenses represented 5% of net sales, and included \$0.4 million in royalty expense related to the intellectual property rights agreement with Pro-Fit.

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### GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses for the year ended December 31, 2006 decreased \$11.6 million or 52% from 2005. \$0.5 million of the reduction from 2005 was the result of restructuring and impairment charges recorded in 2005, and bad debt expense recorded in 2005 of \$5.9 million as compared to bad debt recoveries in 2006 of \$0.5 million. Other general and administrative costs in 2006 as compared to 2005 include reductions in legal costs by \$1.9 million; lower employee and benefit costs by \$1.9 million; reduced facility costs of \$0.6 million; and reductions in other administrative and travel costs of \$1.4 million; offset by approximately \$0.7 million in increased professional and audit fees; and stock based compensation expense of \$0.4 million associated with the implementation of FAS 123(R).

General and administrative expenses increased approximately \$0.7 million (4%) in 2005 compared to 2004. This increase in general and administrative expenses resulted from an net increase of \$2.6 million in the reserve for doubtful accounts recorded in 2005, higher legal expenses of approximately \$3.5 million related primarily to the Pro-Fit litigation, and an impairment charge to goodwill of \$0.5 million incurred in connection with the 2005 restructuring plan; offset by reductions in employment levels and associated costs in connection with the restructuring plan.

Included in general and administrative expenses for the year ended December 31, 2004 are charges of \$4.3 million related primarily to the write-down of receivables due from one customer. We also recorded an accounts receivable reserve of \$5.0 million (or 9% of net sales) in the fourth quarter of 2004 based on management's estimate of the collectibility of accounts receivable

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primarily related to two other customers. In the first quarter of 2004, we incurred additional restructuring charges of \$0.4 million related to the final residual costs associated with our restructuring plan implemented in the fourth quarter of 2003.

### RESTRUCTURING CHARGES

Restructuring costs in 2005 were the result of the adoption of our 2005 restructuring plan. Restructuring costs recorded in the third quarter of 2005 were \$6.2 million. Additional costs of \$0.2 million were incurred in the fourth quarter of 2005. Total restructuring costs of \$6.4 million were recorded in the Consolidated Statement of Operations for the year ended December 31, 2005 as follows (in millions):

Cost of goods sold .....	\$	3.4
Operating expenses:		
General & administrative expenses .....		0.5
Restructuring charges .....		2.5
		-----
Total restructuring costs .....	\$	6.4
		=====

During the first quarter of 2004, we incurred restructuring charges of \$0.4 million for final residual costs associated with our 2003 restructuring plan.

### INTEREST EXPENSE, NET

Net interest expense for the year ended December 31, 2006 decreased from 2005 by approximately \$0.4 million principally as a result of interest earnings in 2006 from the note receivable.

Interest expense increased approximately \$0.2 million (or 33%) to \$1.1 million for 2005 from \$0.8 million for 2004. The increase in interest expense was primarily due to higher debt levels associated with the \$12.5 million 6% secured convertible notes payable dated November 2004, the \$0.8 million 6.5% mortgage note payable to First National Bank dated June 2004, and the \$0.9 million 6.5% equipment note payable to First National Bank dated November 2004 which were outstanding for the entire year in 2005 compared to a partial year in 2004; partially offset by the repayment of a remaining \$1.4 million due pursuant to a note payable and a reduction in amounts due to factor in 2005.

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### INCOME TAXES

Income tax provisions for the year ended December 31, 2006 principally include a royalty tax from the Inland Revenue Department in Hong Kong applicable to 2005, net of an estimated tax benefit for 2006 foreign losses and minimum federal and state filing fees.

The provision for income taxes for the year ended December 31, 2005 principally reflects the elimination of the net deferred tax asset in 2005 of \$1.0 million, and estimated foreign taxes. Based on the Company's net operating losses, there is not sufficient evidence to determine that it is more likely than not that the Company will be able to utilize its net operating loss carry forwards to offset future taxable income.

The provision for income taxes was \$2.3 million for the year ended

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December 31, 2004 .The income tax provision primarily reflects a charge of \$1.8 million as a result of a decrease in the value of net deferred tax assets, and foreign income taxes of \$0.5 million on foreign earnings.

### LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes selected financial data (amounts in thousands):

	DECEMBER 31, 2006	DECEMBER 31, 2005
	-----	-----
Cash and cash equivalents .....	\$ 2,935	\$ 2,277
Total assets .....	25,694	30,321
Current debt .....	22,471	14,851
Non-current debt .....	1,536	14,558
Stockholders' equity .....	1,686	912

### CASH AND CASH EQUIVALENTS

Our cash is held with financial institutions. Substantially all of the balances at December 31, 2006 and 2005 are in excess of federally insured limits. As of December 31, 2006 and 2005 we had restricted cash balances of \$50,000 related to cash collateral for a letter of credit with Wells Fargo Bank.

### FINANCING ARRANGEMENTS

The Company currently does not have an active financing arrangement to provide for working capital requirements and cash provided by operating activities is our only recurring source of funds. We financed building, land and equipment purchases through notes payable and capital lease obligations expiring through June 2011. These obligations bear interest at rates of 6.5% and 6.6% per annum, and under these obligations, we are required to make monthly payments of principal and interest. In June 2006 we entered into a note payable with our legal counsel in exchange for legal fees outstanding to this firm related to our Pro-Fit litigation. The note agreement provides for monthly payments against the note in amounts equal to payments we receive from our note receivable until such time as the note is paid in full. The note receivable is fully pledged as collateral against this note payable.

A factoring agreement for the purchase of eligible receivables from our Hong Kong subsidiary exists with East Asia Heller, wherein the factor purchases our eligible accounts receivable and may assume the credit risk with respect to those accounts for which the factor has given its prior approval. If the factor does not assume the credit risk for a receivable, the collection risk associated with the receivable remains with us. The agreement provides for us to pay a fixed commission rate and for us to borrow up to 80% of eligible accounts receivable. Interest is charged at 1.5% over the Hong Kong Dollar prime rate. However, during 2005 and 2006 the factor declined to advance funds to us under this agreement. Accordingly, no outstanding advances as of December 31, 2006 and 2005 existed.

In 2005, we entered into a letter of credit with Wells Fargo Bank. This letter of credit provides for a maximum of \$50,000, expires in June 2007 and is secured by cash on hand managed by Wells Fargo Bank. At December 31, 2006, outstanding letters of credit under the Wells Fargo facility were \$50,000. This letter is pledged as collateral for a bond posted in connection with our

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litigation with Todo Textile, S. A. in which a settlement agreement was reached in 2006. Upon release of the bond held by the court in this matter, the letter of credit will be released and the settlement amount of \$40,000 paid from the proceeds.

The outstanding balance of our demand notes payable to related parties at December 31, 2006 and 2005 was \$665,000. Included is a \$500,000 convertible secured promissory note payable with interest at 11% payable quarterly. The note is due on demand and is convertible into common stock at the election of the holder at a rate of \$4.50 per share. The remaining demand notes totaling \$165,000 bear interest at 0%-10%, have no scheduled monthly payments, and are due within fifteen days from demand.

### CASH FLOWS

The following table summarizes our cash flow activity for the years ended December 31, 2006, 2005, and 2004 (amounts in thousands):

	2006 -----	2005 -----	2004 -----
Net cash provided by (used in)			
operating activities .....	\$ 2,020	\$ 1,112	\$ (11,382)
Net cash used in investing			
activities .....	(345)	(1,454)	(3,616)
Net cash provided by (used in)			
financing activities .....	(1,018)	(2,841)	6,016
Net increase (decrease) in cash and cash equivalents .....	657	(3,183)	(8,982)

### OPERATING ACTIVITIES

Cash and cash equivalents for the year ended December 31, 2006 increased by \$0.7 million from December 31, 2005 principally arising from cash generated by operating activities, net of payments on notes payable and capital leases.

Cash provided by operating activities is our only recurring source of funds and was \$2.0 million for the year ended December 31, 2006. The cash generated by operating activities during 2006 resulted primarily from net earnings (before non-cash expenses) of approximately \$2.3 million; reductions in inventory net of applied reserves of \$2.5 million; and \$1.0 million in reductions in accounts receivable net of reserves applied; net of reductions in accounts payable of \$2.6 million and reductions in other liabilities, net of approximately \$1.2 million.

The net decrease in inventory of \$2.5 million reflects the Company's efforts to dispose of and lower slower-moving and obsolete inventory components. The cost of net inventories eliminated during the year was \$8.6 million, and reserves applicable to this inventory of \$6.1 million were applied to these dispositions. Accounts receivable for the year ended December 31, 2006 declined by \$2.1 million primarily as a result of improved collections and faster turns of accounts receivable, and by approximately \$0.7 million in accounts written-off. Accounts receivable reserves declined by \$1.1 million from the write-off of uncollectible accounts and by approximately \$0.4 million from the collection of accounts reserved for in prior years. In addition, during 2006 collections of accounts written-off in prior years was \$0.5 million.

The increase in cash provided by operating activities during the year ended December 31, 2005 resulted from, among other changes, a \$10.6 million decrease in accounts receivable, including the collection of a \$4.5 million receivable from one customer; a \$3 million increase in accounts payable; a \$2.8 million decrease in inventories; a \$2.1 million increase in accrued legal costs;

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substantially offset by a net loss of \$29.5 million.

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At December 31, 2005, accounts receivable from Azteca Productions International ("Azteca"), a significant customer, was approximately \$10,968,000 less a reserve of \$7,528,000, totaling \$3,440,000, net. In February 2006, the Company accepted a note agreement from Azteca which provides for total payments including principal and interest of \$4.0 million in exchange for the net outstanding accounts receivable balance. The balance of the note receivable at December 31, 2005 of \$3,440,000 reflects a \$560,000 charge 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 decrease in cash provided by operations for 2004 resulted primarily from a net loss of \$17.6 million together with a net increase of \$7.6 million in accounts receivable due primarily to slower customer collections of receivables during the year. This decrease was partially offset by a \$4 million net increase in the allowance for doubtful accounts and a \$7.8 million decrease in inventories.

### INVESTING ACTIVITIES

Net cash used in investing activities for the year ended December 31, 2006 and 2005 consisted of capital expenditures of \$0.3 million and \$1.5 million, respectively for leasehold improvements and equipment purchases.

Net cash used in investing activities for the year ended December 31, 2004 consisted of capital expenditures of \$3.6 million for computer equipment, the purchase of additional TALON zipper equipment and building, land and leasehold improvements related to the TALON manufacturing facility in North Carolina. The building and land purchase of the TALON manufacturing facility was reported as a non-cash financing transaction.

### FINANCING ACTIVITIES

Net cash used in financing activities for the years ended December 31, 2006 and 2005 primarily reflects the repayment of notes payable and capital lease obligations. In 2006 net cash used in financing activities also included \$0.6 in collections from the note receivable. In 2005 cash used in financing activities also included, the repayment of borrowings under a bank line of credit partially offset by proceeds from the exercise of stock options and warrants.

Net cash provided by financing activities for the year ended December 31, 2004 primarily reflects funds raised from secured convertible promissory notes of \$12.5 million, the exercise of stock options and warrants, proceeds from notes payable and a capital lease obligation, offset by the repayment of borrowings under our credit facility and notes payable.

We currently satisfy our working capital requirements primarily through cash flows generated from operations. As the major apparel industry brands continue to outsource apparel manufacturing to offshore locations, our foreign customers, though backed by U.S. brands and retailers, will continue to increase. This makes traditional financing arrangements with U.S. banks and financial institutions difficult and accordingly we continue to evaluate non-traditional financing of our foreign assets.

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We believe that our existing cash and cash equivalents and anticipated cash flows from our operating activities and available financing will be sufficient to fund our minimum working capital and capital expenditure needs for at least the next twelve months. This conclusion is based on the belief and expectation that we have successfully completed the restructuring plan adopted in 2005 and that our strategic plan and the company's current structure will allow for continued profitability; that we will collect our note and accounts receivable in accordance to existing terms; and that we will complete a refinancing of the convertible notes payable by their maturity date in November 2007. We have discussed the refinancing of these notes with the current note holders and with various financial and investment institutions. We believe that we will be successful in completing a modification or replacement of these notes prior to their maturity.

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If we are unable to successfully complete the refinancing of the convertible notes or to collect our note and accounts receivable, or experience greater than anticipated reductions in sales, we may need to raise additional capital, or obtain alternate financing to repay the convertible notes, or further reduce the scope of our business in order to fully satisfy our future short-term liquidity requirements. If we cannot raise additional capital or arrange for alternate financing or reduce the scope of our business in response to a substantial decline in sales, we may default on the payment of the convertible notes payable. The event of a default on the payment of these notes will materially affect the business operations in the long-term, however the on-going operations for 2007 are nevertheless anticipated to substantially continue throughout the 2007 year-end as operations from assets not pledged to these notes continues.

The extent of our future long-term capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of future acquisitions, and our expansion into foreign markets. Our need for additional long-term financing includes the integration and expansion of our operations to exploit our rights under our TALON trade name, the expansion of our operations in Asia and other markets and the further development of our waistband technology. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise additional debt or equity financing in order to provide for our operations. We are continually evaluating various financing strategies to be used to expand our business and fund future growth or acquisitions. There can be no assurance that additional debt or equity financing will be available on acceptable terms or at all. If we are unable to secure additional financing, we may not be able to execute our plans for expansion, including expansion into foreign markets to promote our TALON brand trade name, and we may need to implement additional cost savings initiatives.

### CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

The following summarizes our contractual obligations at December 31, 2006 and the effects such obligations are expected to have on liquidity and cash flow in future periods:

Payments Due by Period

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Contractual Obligations	Total	Less than 1 Year	1-3 Years	4-5 Years	After 5 Years
Demand notes payable					
to related parties (1)	\$ 1,181,000	\$ 1,181,000	\$ --	\$ --	\$ --
Capital lease obligations	\$ 1,027,000	\$ 506,000	\$ 521,000	\$ --	\$ --
Operating leases .....	\$ 1,421,000	\$ 437,000	\$ 754,000	\$ 229,000	\$ 1,000
Notes payable .....	\$ 2,426,000	\$ 1,193,000	\$ 604,000	\$ 629,000	\$ --
Convertible notes payable	\$13,143,000	\$13,143,000	\$ --	\$ --	\$ --
	-----	-----	-----	-----	-----
Total Obligations ..	\$19,198,000	\$16,460,000	\$ 1,879,000	\$ 858,000	\$ 1,000
	=====	=====	=====	=====	=====

(1) The majority of notes payable to related parties are due on demand with the remainder due and payable on the fifteenth day following the date of delivery of written demand for payment, and include accrued interest payable through December 31, 2006.

At December 31, 2006 and 2005, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

RELATED PARTY TRANSACTIONS

For a description of transactions to which we were or will be a party, and in which any director, executive officer, or shareholder of more than 5% of our common stock or any member of their immediate

family had or will have a direct or indirect material interest, see Note 16 of the Notes to the consolidated financial statements included in Item 8 of this Report.

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions for the reporting period and as of the financial statement date. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities and the reported amounts of revenue and expense. Actual results could differ from those estimates.

Critical accounting policies are those that are important to the portrayal of our financial condition and results, and which require us to make difficult, subjective and/or complex judgments. Critical accounting policies cover accounting matters that are inherently uncertain because the future resolution of such matters is unknown. We believe the following critical

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accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

- o Accounts receivable balances are evaluated on a continual basis and allowances are provided for potentially uncollectible accounts based on management's estimate of the collectibility of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of its ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known.
- o Inventories are stated at the lower of cost or market value. Inventory is evaluated on a continual basis and reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Inventory reserves are recorded for damaged, obsolete, excess and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory.
- o We record deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if we believe 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. If we determine that we may not realize all of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. We believe that our 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 the balance sheet

and results of operations. See Notes to consolidated financial statements, Note 12, "Income Taxes".

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- o We record impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy have historically caused us to reassess the carrying amount of our long-lived assets. Long-lived assets are evaluated on a continual basis and impairment adjustments are made based upon management's valuations. As part of our 2005 restructuring plan, certain long-lived assets, primarily machinery and equipment, were impaired and their values adjusted accordingly.
- o 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.
- o Upon approval of a restructuring plan by management, we record restructuring reserves for certain costs associated with facility closures and business reorganization activities as they are incurred or when they become probable and estimable. Such costs are recorded as a current liability. We record 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 when they became probable and estimable and on the accrual basis for one-time benefit arrangements. We record 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 us 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. We review the status of restructuring activities on a quarterly basis and, if appropriate, records changes based on updated estimates. See Note 11, "2005 Restructuring Costs".
- o 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

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ultimate resolution of these claims could affect our future results of operations for any particular quarterly or annual period should our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued.

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### 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. We do not believe that SFAS No. 157 will have a material impact on our 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 our financial position, results of operations or cash flows.

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. We are 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

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pertaining to beneficial interests that itself is 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. We do not believe that SFAS No. 155 will have a material impact on the Company's financial position, results of operations or cash flows.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

All of our sales are denominated in United States dollars or the currency of the country in which our products originate. We are exposed to market risk for fluctuations in the foreign currency exchange rates for certain product purchases that are denominated in Hong Kong dollars, Chinese Yuan's and British Pounds. During 2004, we purchased forward exchange contracts for British Pounds to hedge the payments of product purchases. We do not intend to purchase additional contracts to hedge the exchange exposure for future product purchases. There were no hedging contracts outstanding as of December 31, 2006. Currency

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fluctuations can increase the price of our products to foreign customers which can adversely impact the level of our export sales from time to time. The majority of our cash equivalents are held in United States dollars in various bank accounts and we do not believe we have significant market risk exposure with regard to our investments. At December 31, 2006, none of our indebtedness was subject to interest rate fluctuations.

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### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Tag It Pacific Inc.  
Woodland Hills, California

We have audited the consolidated balance sheets of Tag It Pacific Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated

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statements of operations, stockholders' equity and convertible redeemable preferred stock, and cash flows for each of the two years in the period ended December 31, 2006. Our audits also included the financial statement schedules of Tag It Pacific Inc., listed in Item 15(a). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tag It Pacific Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements, taken as a whole, present fairly in all material respects the information set forth therein.

/S/ SINGER LEWAK GREENBAUM & GOLDSTEIN LLP

Los Angeles, California  
April 9, 2007

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors  
Tag-It Pacific, Inc.  
Los Angeles, California

We have audited the accompanying consolidated statements of operations, stockholders' equity and convertible redeemable preferred stock and cash flows of Tag-It Pacific, Inc. and subsidiaries for the year ended December 31, 2004. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in

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the financial statements and assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provided a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations of Tag-It Pacific, Inc. and subsidiaries and their cash flows for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO Seidman, LLP

Los Angeles, California  
March 31, 2005

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### TAG-IT PACIFIC, INC. CONSOLIDATED BALANCE SHEETS

	December 31, 2006	December 31, 2005
	-----	-----
<b>Assets</b>		
<b>Current Assets:</b>		
Cash and cash equivalents .....	\$ 2,934,673	\$ 2,277,397
Accounts receivable, net .....	4,664,766	5,652,990
Note receivable .....	1,378,491	662,369
Inventories, net .....	3,051,220	5,573,099
Prepaid expenses and other current assets .....	541,034	618,577
	-----	-----
Total current assets .....	12,570,184	14,784,432
Property and equipment, net .....	5,623,040	6,438,096
Fixed assets held for sale .....	826,904	826,904
Note receivable, less current portion .....	1,420,969	2,777,631
Due from related parties .....	675,137	655,489
Other intangible assets, net .....	4,139,625	4,255,125
Other assets .....	437,569	583,117
	-----	-----
Total assets .....	\$ 25,693,428	\$ 30,320,794
	=====	=====
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable .....	\$ 4,006,241	\$ 6,719,226
Accrued legal costs .....	427,917	2,520,111
Other accrued expenses .....	3,359,267	4,168,552
Demand notes payable to related parties .....	664,970	664,971
Current portion of capital lease obligations .....	432,728	590,884
Current portion of notes payable .....	1,107,207	186,837
Current portion of secured convertible promissory notes .....	12,472,622	--
	-----	-----
Total current liabilities .....	22,470,952	14,850,581

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Capital lease obligations, less current portion .....	474,733	856,495
Notes payable, less current portion .....	1,061,514	1,261,018
Secured convertible promissory notes .....	--	12,440,623
	-----	-----
Total liabilities .....	24,007,199	29,408,717
	-----	-----
Commitments and contingencies (Note 13)		
Stockholders' Equity:		
Preferred stock Series A, \$0.001 par value; 250,000 shares authorized; no shares issued or outstanding .....	--	--
Common stock, \$0.001 par value, 100,000,000 shares authorized; 18,466,433 shares issued and outstanding at December 31, 2006; 18,241,045 at December 31, 2005 .....	18,466	18,241
Additional paid-in capital .....	51,792,502	51,327,878
Accumulated deficit .....	(50,124,739)	(50,434,042)
	-----	-----
Total stockholders' equity .....	1,686,229	912,077
	-----	-----
Total liabilities and stockholders' equity .....	\$ 25,693,428	\$ 30,320,794
	=====	=====

See accompanying notes.

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TAG-IT PACIFIC, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004
	-----	-----	-----
Net sales .....	\$ 48,825,002	\$ 47,331,176	\$ 55,109,481
Cost of goods sold .....	34,356,034	47,070,381	44,813,736
	-----	-----	-----
Gross profit .....	14,468,968	260,795	10,295,745
Selling expenses .....	2,777,772	2,928,659	2,899,329
General and administrative expenses .....	10,670,311	22,267,070	21,508,607
Restructuring charges .....	--	2,474,281	414,675
	-----	-----	-----
Total operating expenses .....	13,448,083	27,670,010	24,822,611
Income (loss) from operations .....	1,020,885	(27,409,215)	(14,526,866)
Interest expense, net .....	677,682	1,069,015	804,888
	-----	-----	-----
Income (loss) before income taxes .....	343,203	(28,478,230)	(15,331,754)



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Provision for income taxes .....	33,900	1,059,479	2,277,214
	-----	-----	-----
Net income (loss) .....	309,303	(29,537,709)	(17,608,968)
Less: Preferred stock dividends .....	--	--	(30,505)
	-----	-----	-----
Net income(loss) to common shareholders ..	\$ 309,303	\$ (29,537,709)	\$ (17,639,473)
	=====	=====	=====
Basic income(loss) per share .....	\$ 0.02	\$ (1.62)	\$ (1.02)
	=====	=====	=====
Diluted income( loss) per share .....	\$ 0.02	\$ (1.62)	\$ (1.02)
	=====	=====	=====
Basic weighted average shares outstanding .	18,377,484	18,225,851	17,316,202
	=====	=====	=====
Diluted weighted average shares outstanding	18,955,796	18,225,851	17,316,202
	=====	=====	=====

See accompanying notes.

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TAG-IT PACIFIC, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND CONVERTIBLE  
REDEEMABLE PREFERRED STOCK YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

	Common Stock		Preferred Stock Series A	
	Shares	Amount	Shares	Amount
	-----	-----	-----	-----
BALANCE, JANUARY 1, 2004 .....	11,508,201	\$ 11,510	--	--
Conversion of preferred stock Series C and accrued dividends .....	700,144	700		--
Conversion of preferred stock Series D .....	5,728,180	5,728		--
Warrants issued in private placement transaction .....	--	--	--	--
Common stock issued upon exercise of options and warrants .....	214,276	214	--	--
Common stock and warrants issued for services .....	20,500	21	--	--
Tax benefit from exercise of stock options .....	--	--	--	--
Preferred stock dividends .....	--	--	--	--
Net loss .....	--	--	--	--
	-----	-----	-----	-----
BALANCE, DECEMBER 31, 2004 .....	18,171,301	18,173		--
Common stock issued upon				

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exercise of options and warrants .....	69,744	68		--
Net loss .....	--	--	--	--
BALANCE, DECEMBER 31, 2005 .....	18,241,045	18,241	--	--
Common stock issued for services .....	225,388	225	--	--
Stock based compensation .....	--	--	--	--
Net income .....	--	--	--	--
BALANCE, DECEMBER 31, 2006 .....	18,466,433	\$ 18,466	--	--

	Additional Paid-In Capital	Retained Earnings (Deficit)	Total	Convertible R Preferred Series Shares
BALANCE, JANUARY 1, 2004 .....	\$ 23,890,356	\$ (3,256,860)	\$ 43,563,699	759,494
Conversion of preferred stock Series C and accrued dividends .....	3,353,008	--	3,353,708	(759,494)
Conversion of preferred stock Series D .....	22,912,965	--	--	--
Warrants issued in private placement transaction .....	189,815	--	189,815	--
Common stock issued upon exercise of options and warrants .....	557,514	--	557,728	--
Common stock and warrants issued for services .....	85,710	--	85,731	--
Tax benefit from exercise of stock options .....	84,034	--	84,034	--
Preferred stock dividends .....	--	(30,505)	(30,505)	--
Net loss .....	--	(17,608,968)	(17,608,96)	--
BALANCE, DECEMBER 31, 2004 .....	51,073,402	(20,896,333)	30,195,242	--
Common stock issued upon exercise of options and warrants .....	--	254,476	254,544	--
Net loss .....	--	(29,537,70)	(29,537,70)	--
BALANCE, DECEMBER 31, 2005 .....	51,327,878	(50,434,04)	912,077	--
Common stock issued for services .....	102,504	--	102,729	--
Stock based compensation .....	362,120	--	362,120	--
Net income .....	--	309,303	309,303	--
BALANCE, DECEMBER 31, 2006 .....	\$ 51,792,502	\$ (50,124,739)	1,686,229	--

See accompanying notes.

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TAG-IT PACIFIC, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Dec
	-----	-----	-----
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss) .....	\$ 309,303	\$ (29,537,709)	(1)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization .....	1,523,225	1,931,990	
Decrease in deferred income taxes .....	--	1,000,000	
Common stock and warrants issued for services .....	32,729	--	
Stock based compensation .....	362,120		
Increase(decrease) in allowance for doubtful accounts .....	(1,117,500)	2,630,759	
Increase(decrease) in inventory valuation reserve ....	(6,064,000)	940,973	
Asset impairment due to restructuring .....	--	2,343,531	
Impairment of goodwill .....	--	450,000	
Disposal of assets .....	129,179	--	
Changes in operating assets and liabilities:			
Accounts receivable .....	2,086,076	10,666,295	(
Inventories .....	8,585,879	2,791,747	
Prepaid expenses and other current assets .....	77,543	1,880,443	
Other assets .....	(140,217)	314,998	
Accounts payable .....	(2,587,985)	2,986,302	(
		2,113,197	
Accrued legal costs .....	(442,194)		
Other accrued expenses .....	(733,767)	671,348	
Income taxes payable .....	(480)	(71,589)	
	-----	-----	
Net cash provided by (used in) operating activities ....	2,019,911	1,112,285	(1)
	-----	-----	
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from sale of equipment .....	2,500	--	
Acquisition of property and equipment .....	(347,188)	(1,453,848)	(
	-----	-----	
Net cash used in investing activities .....	(344,688)	(1,453,848)	(
	-----	-----	
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Note receivable collections .....	640,539	--	
Proceeds from secured convertible promissory notes ....	--	--	1
Proceeds from exercise of stock options and warrants ...	--	254,544	
(Repayment) of line of credit and due to factor, net ...	--	(614,506)	(
Proceeds from capital lease obligation .....	--	--	
Payment of capital lease obligations .....	(604,351)	(906,765)	
Proceeds from notes payable .....	--	--	
Repayment of notes payable .....	(1,054,135)	(1,574,975)	(
	-----	-----	
Net cash (used in) provided by financing activities ....	(1,017,947)	(2,841,702)	
	-----	-----	
Net increase (decrease) in cash and cash equivalents .....	657,276	(3,183,265)	(
Cash and cash equivalents, beginning of year .....	2,277,397	5,460,662	1
	-----	-----	
Cash and cash equivalents, end of year .....	\$ 2,934,673	\$ 2,277,397	\$
	=====	=====	=====

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### SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash received (paid) during the year for:			
Interest paid .....	\$ (1,045,881)	\$ (1,135,460)	\$
Interest received .....	\$ 368,090	33,931	
Income taxes paid .....	\$ (33,900)	(64,064)	
Income taxes received .....	\$ --	\$ 39,571	
Non-cash financing activity:			
Capital lease obligation .....	\$ 64,432	\$ 273,376	\$
Accounts receivable, net converted to notes receivable	\$ 1,775,000	\$ 3,440,000	\$
Preferred Series D stock converted to common stock ...	\$ --	\$ --	\$ 2
Preferred Series C stock converted to common stock ...	\$ --	\$ --	\$
Accrued dividends converted to common stock .....	\$ --	\$ --	\$
Mortgage note payable .....	\$ --	\$ --	\$
Warrants issued to placement agent .....	\$ --	\$ --	\$

See accompanying notes.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### NATURE OF BUSINESS

Tag-It Pacific, Inc. (the "Company") is an apparel company that specializes in the distribution of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. The Company acts as a full service outsourced trim management department for manufacturers, a specified supplier of trim items to owners of specific brands, brand licensees and retailers, a manufacturer and distributor of zippers under the TALON brand name and a distributor of stretch waistbands that utilize licensed patented technology under the TEKFIT brand name.

##### ORGANIZATION AND BASIS OF PRESENTATION

Tag-It Pacific, Inc. is the parent holding company of Tag-It, Inc., a California corporation, Tag-It Pacific (HK) Ltd., a BVI corporation, Tag-It de Mexico, S.A. de C.V., A.G.S. Stationery, Inc., a California corporation (collectively, the "Subsidiaries"), all of which were consolidated under a parent limited liability company on October 17, 1997 and became wholly-owned subsidiaries of the Company immediately prior to the effective date of the Company's initial public offering in January 1998. Immediately prior to the initial public offering, the outstanding membership units of Tag-It Pacific LLC were converted to 2,470,001 shares of Common Stock of the Company. In January 2000, the Company formed Tag-It Pacific Limited, a Hong Kong corporation, and in April 2000, the Company formed Talon International, Inc., a Delaware corporation. During 2006 we formed two wholly owned subsidiaries of Tag-It Pacific, Inc.; Talon Zipper (Shenzhen) Company Ltd. in China, and Talon International Pvt. Ltd., in India. All newly formed corporations are 100% wholly-owned Subsidiaries of Tag-It Pacific, Inc. Logistica en Avios, S.A. de C.V. was an affiliated entity over which the Company exercised control, and as such, is accounted for in the same manner as a wholly-owned subsidiary.

All significant intercompany accounts and transactions have been eliminated in consolidation. Assets and liabilities of foreign subsidiaries are

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translated at rates of exchange in effect at the close of the period. Revenues and expenses are translated at the weighted average of exchange rates in effect during the year. The resulting translation gains and losses are deferred and are shown as a separate component of stockholders' equity, if material, and transaction gains and losses, if any, are recorded in the consolidated statement of income in the period incurred. During 2006, 2005 and 2004, foreign currency translation and transaction gains and losses were not material. The Company does not engage in hedging activities with respect to exchange rate risk.

### USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

### CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents. The Company had approximately \$2.9 million and \$2.2 million at financial institutions in excess of federally insured limits at December 31, 2006 and 2005.

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## TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### ALLOWANCE FOR DOUBTFUL ACCOUNTS

We are required to make judgments as to the collectibility of accounts receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts receivable that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables to their net realizable value. We record these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on our historical experience, for issues not yet identified.

### INVENTORIES

Inventories are stated at the lower of cost or market value and are all substantially finished goods. Inventory reserves are recorded for damaged, obsolete, excess and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory.

Inventories consist of the following:

Year Ended December 31,

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	2006	2005
Finished goods .....	\$ 4,293,220	\$12,879,099
Less reserves .....	1,242,000	7,306,000
Total inventories .....	\$ 3,051,220	\$ 5,573,099

PROPERTY AND EQUIPMENT AND FIXED ASSETS HELD FOR SALE

Property and equipment are recorded at historical cost. Maintenance and repairs are expensed as incurred. Upon retirement or other disposition of property and equipment, the related cost and accumulated depreciation or amortization are removed from the accounts and any gains or losses are included in results of operations. During the year ended December 31, 2005 the Company wrote-off fully depreciated equipment, films, dies and art designs no longer in service, and changed its estimates of the expected useful lives of the dies and molds to 3 months or 1 year, depending upon the nature of the tool.

Depreciation of property and equipment is computed using the straight-line method based on estimated useful lives as follows:

Furniture and fixtures	5 years
Machinery and equipment	5 to 10 years
Computer equipment	5 years
Leasehold improvements	Term of the lease or the estimated life of the related improvements, whichever is shorter.
Dies, and molds	3 months to 1 years
Idle equipment	5 to 10 years

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Property and equipment consist of the following:

	Year Ended December 31,	
	2006	2005
Furniture and fixtures .....	\$ 582,832	\$ 551,623
Machinery and equipment .....	1,682,296	3,319,786
Computer equipment .....	3,422,058	3,325,997
Leasehold improvements .....	214,807	139,803
Dies, and molds .....	106,273	106,273
Idle equipment .....	4,434,980	2,806,475
	10,443,246	10,249,958
Accumulated depreciation and amortization .....	4,820,206	3,811,862
Net property and equipment .....	\$ 5,623,040	\$ 6,438,096

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Depreciation expense for the years ended December 31, 2006, 2005 and 2004 was \$1,090,000, \$1,499,000, and \$1,277,000, respectively.

During the year ended December 31, 2005, the Company wrote-off fixed assets with a net book value of \$2,036,000 in connection with the 2005 restructuring plan.

Idle equipment is principally machinery and equipment used for the production of zipper chain and the assembly of finished zippers. This equipment was originally associated with the production and assembly facilities in North Carolina and in Mexico, and was temporarily rendered idle with the closing of these operations in connection with the 2005 Restructuring Plan. The Company intends to redeploy this equipment during the next year within production operations being established in Asia and India. The equipment continues to be depreciated based upon its estimated useful lives.

Fixed assets held for sale consists of the North Carolina land and manufacturing facility. Management has the authority and has committed to sell the asset; the asset is listed for sale with a commercial real estate agent who is actively marketing the property; the sale of the asset is probable and the sale is expected to be completed within one year. See Note 11, "2005 Restructuring Plan".

### GOODWILL AND OTHER INTANGIBLE ASSETS

Intangible assets consist of goodwill, tradename, and exclusive license and intellectual property rights. Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB Statement No. 142, Goodwill and Other Intangible Assets. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives, which average 5 years, to their estimated residual values, and reviewed for impairment in accordance with FASB Statement No. 144, Accounting for Impairment or Disposal of Long-Lived Assets.

At December 31, 2006, the Company evaluated its Other Intangible Assets and determined that there was no impairment of these assets and made no changes to the net carrying amount of Tradename for the years ended December 31, 2006 and 2005. At December 31, 2005, the Company evaluated its Goodwill and determined that an impairment adjustment in the amount of \$450,000 related to goodwill was necessary to reduce the carrying value of goodwill to zero. Amortization expense related to exclusive license and

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

intellectual property rights of \$115,500 were recorded for each of the years ended December 31, 2006, 2005 and 2004.

Goodwill and other intangible assets as of December 31, 2006 and 2005 are as follows:

Year Ended December31,

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	2006	2005
Goodwill .....	\$ --	\$ 500,000
Accumulated amortization .....	--	(50,000)
Impairment write-off .....	--	(450,000)
Goodwill, net .....	\$ --	\$ --
Other Intangible Assets:		
Tradename .....	\$ 4,110,750	\$ 4,110,750
Accumulated amortization .....	--	--
Tradename, net .....	4,110,750	4,110,750
Exclusive license and intellectual property rights .....	577,500	577,500
Accumulated amortization .....	(548,625)	(433,125)
Exclusive license and intellectual property rights, net .....	28,875	144,375
Other intangible assets, net .....	\$ 4,139,625	\$ 4,255,125

The estimated amortization expense for these assets for succeeding years is \$28,875 for 2007.

IMPAIRMENT OF LONG-LIVED ASSETS

We record impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy have historically caused us to reassess the carrying amount of our long-lived assets. During the year ended December 31, 2005, the Company recorded asset impairment charges in connection with its 2005 Restructuring Plan (See Note 11).

INCOME TAXES

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 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 we believe 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



TAG-IT PACIFIC, INC.  
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in recent years and whether sufficient income is expected in future years in order to utilize the deferred tax asset.

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 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."

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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	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, 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

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the awards, and actual and projected employee stock option exercise behaviors. The Company estimates expected

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

#### 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

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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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 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 our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued.

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### 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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

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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 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:

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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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 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

### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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
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Unsecured notes payable to a director of the

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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.

### 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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 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		



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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
	=====	=====

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. 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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 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.

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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. 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.

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

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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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 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

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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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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### 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 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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the activity for the periods:

	Number of Shares	Weighted Average Exercise Price
Employee and Director		
-----		
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

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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.

The following table summarizes the activity for the periods:

	Number of Shares	Weighted Average Exercise Price
NON-EMPLOYEES		
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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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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.

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:

Employee and Director	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Intrinsic 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.

NON-EMPLOYEE OPTIONS & WARRANTS:	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Intrinsic 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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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



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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.

### 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:

Years ended:	December 31, 2006			December 31, 2004	
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Shares (Denominator)
Basic income (loss):					
pershare:					
Income (loss) available to common stockholders ...	\$ 309,303	18,377,484	\$ 0.02	\$(29,537,709)	18,225,851
Effect of dilutive securities:					
Options .....	--	578,312	0.00	--	--
Warrants .....	--	--	--	--	--
Income (loss) available to common stockholders .....	\$ 309,303	18,955,796	\$ 0.02	\$(29,537,709)	18,225,851

Years ended:	December 31, 2004		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic income (loss):			
pershare:			
Income (loss) available to common stockholders ...	\$(17,639,47)	17,316,202	\$ (1.02)
Effect of dilutive securities:			
Options .....	--	--	--
Warrants .....	--	--	--

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	-----	-----	-----
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.

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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."

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

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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
	=====

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 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
	=====	=====	=====

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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)
	=====	=====	=====

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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)
	-----	-----
	\$ --	\$ --

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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 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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

\$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

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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.

### 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.

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## TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 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 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

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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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 adjudication 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 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



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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 does not believe there will be a material adverse affect on us.

We currently have 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

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### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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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.

### NOTE 14 - GEOGRAPHIC 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 account for these products separately or to justify segmented reporting by product type.

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
	-----	-----	-----
<b>Sales:</b>			
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
	=====	=====	=====
<b>Long-lived Assets:</b>			
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

### TAG-IT PACIFIC, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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,

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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, 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.

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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
-----			
2006			
Revenue .....	\$ 10,573,755	\$ 13,366,944	\$ 14,246,087
Operating income (loss) .....	\$ 170,483	\$ 552,713	\$ 817,722
Net Income(loss) .....	\$ 44,950	\$ 339,115	\$ 654,643
Basic and diluted income (loss) per share .....	\$ 0.00	\$ 0.02	\$ 0.04
2005			
Revenue .....	\$ 9,163,355	\$ 9,472,898	\$ 15,639,646
Operating (loss) income (1,2) .....	\$ (5,002,769)	\$ (10,281,054)	\$ (10,907,621)
Net (loss) income (2) .....	\$ (5,127,754)	\$ (10,284,874)	\$ (12,476,638)
Basic and diluted (loss) per share .....	\$ (0.28)	\$ (0.56)	\$ (0.68)
-----			

(1) The Company recorded restructuring charges of \$6.2 million in the third quarter of 2005 (Note 11).

(2) During 2005, the Company recorded net increases of \$3.7 million to reserves for accounts receivable and inventories, and a decrease in net deferred tax asset resulting in a charge to the provision for income taxes of \$1 million during 2005.

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.

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TAG-IT PACIFIC, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

### 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. Disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable, rather than absolute, assurance of achieving the desired control objectives.

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 at a reasonable assurance level.

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.

### ITEM 9B. OTHER INFORMATION

None.

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## PART III

### ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this Item 10 will appear in the proxy statement for the 2007 Annual Meeting of Stockholders, and is incorporated herein by reference.

### ITEM 11. EXECUTIVE COMPENSATION

Information regarding executive compensation will appear in the proxy statement for the 2007 Annual Meeting of Stockholders, and is incorporated herein by reference.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

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Information regarding security ownership of certain beneficial owners and management and related stockholder matters will appear in the proxy statement for the 2007 Annual Meeting of Stockholders, and is incorporated herein by reference.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information regarding certain relationships and related transactions will appear in the proxy statement for the 2007 Annual Meeting of Stockholders, and is incorporated herein by reference.

### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information regarding principal accountant fees and services will appear in the proxy statement for the 2007 Annual Meeting of Stockholders, and is incorporated herein by reference.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

- (a) FINANCIAL STATEMENTS AND SCHEDULES.

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## 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

Los Angeles, California  
April 9, 2007

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## INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S REPORT ON SCHEDULE II

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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  
 -----

Los Angeles, California  
 March 31, 2005

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SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

COLUMN A	COLUMN B	COLUMN C	COLUMN D	COLUMN E
-----	-----	-----	-----	-----
DESCRIPTION	Balance at Beginning of year	Additions	Deductions	Balance at 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	\$ 2,631,000	\$ 7,528,000	\$ 1,189,000
Reserve for obsolescence deducted from inventories on the balance sheet .....	6,365,000	2,538,000	1,597,000	7,306,000
Valuation reserve deducted from Deferred tax Assets .....	8,900,000	12,547,000	--	21,447,000
	-----	-----	-----	-----
	\$21,351,000	\$17,716,000	\$ 9,125,000	\$29,942,000
	=====	=====	=====	=====
2004				

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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	2,240,000	2,000,000	6,365,000
Valuation reserve deducted from Deferred tax Assets .....	1,119,000	7,781,000	--	8,900,000
	-----	-----	-----	-----
	\$ 9,288,000	\$15,521,000	\$ 3,458,000	\$21,351,000
	=====	=====	=====	=====

(b) Exhibits:

See Exhibit Index attached to this Annual Report on Form 10-K.

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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.

TAG-IT PACIFIC, INC.

/S/ LONNIE D. SCHNELL

By: Lonnie D. Schnell  
Its: Chief Financial Officer

POWER OF ATTORNEY

Each person whose signature appears below constitutes and appoints Stephen Forte and Lonnie D. Schnell, and each of them, as his true and lawful attorneys-in-fact and agents with full power of substitution and resubstitution, for him and his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-K and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the foregoing, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or either of them, or their substitutes, may lawfully do or cause to be done by virtue hereof.

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
-----	-----	-----
/S/ MARK DYNE	Chairman of the Board	April 12, 2007
-----	of Directors	
Mark Dyne		



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/S/ STEPHEN FORTE ----- Stephen Forte	Chief Executive Officer (Principal Executive Officer) and Director	April 12, 2007
/S/ LONNIE D. SCHNELL ----- Lonnie D. Schnell	Chief Financial Officer (Principal Accounting and Financial Officer)	April 12, 2007
/S/ COLIN DYNE ----- Colin Dyne	Director	April 12, 2007
/S/ JONATHAN BURSTEIN ----- Jonathan Burstein	Director	April 12, 2007
----- Brent Cohen	Director	April 12, 2007
/S/ SUSAN WHITE ----- Susan White	Director	April 12, 2007
/S/ RAYMOND MUSCI ----- Raymond Musci	Director	April 12, 2007
/S/ JOSEPH MILLER ----- Joseph Miller	Director	April 12, 2007
/S/ WILLIAM SWEEDLER ----- William Sweedler	Director	April 12, 2007

EXHIBIT INDEX

EXHIBIT NUMBER	EXHIBIT DESCRIPTION
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3.1	Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
3.1.2	Certificate of Designation of Rights, Preferences and Privileges of Series A Preferred Stock. Incorporated by reference to Exhibit A to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998.
3.1.3	Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.4 to Annual Report on Form 10-KSB, filed March 28, 2000.
3.1.4	Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1.3 to Form 8-K filed on August

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4, 2006.

- 3.2 Bylaws of Registrant. Incorporated by reference to Exhibit 3.2 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 4.1 Specimen Stock Certificate of Common Stock of Registrant. Incorporated by reference to Exhibit 4.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 4.2 Rights Agreement, dated as of November 4, 1998, between Registrant and American Stock Transfer and Trust Company as Rights Agent. Incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998.
- 4.3 Form of Rights Certificate. Incorporated by reference to Exhibit B to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998.
- 10.1 Form of Indemnification Agreement. Incorporated by reference to Exhibit 10.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.2 Promissory Note, dated September 30, 1996, provided by Tag-It, Inc. to Harold Dyne. Incorporated by reference to Exhibit 10.21 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.3 Promissory Note, dated June 30, 1991, provided by Tag-It, Inc. to Harold Dyne. Incorporated by reference to Exhibit 10.23 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.4 Promissory Note, dated January 31, 1997, provided by Tag-It Inc. to Mark Dyne. Incorporated by reference to Exhibit 10.24 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.5 Promissory Note, dated February 29, 1996, provided by A.G.S. Stationary, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.25 of Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.6 Promissory Note, dated January 19, 1995, provided by Pacific Trim & Belt, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.26 to Form SB-2 filed on October 21, 1997, and the amendments thereto.

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EXHIBIT NUMBER	EXHIBIT DESCRIPTION
10.7(2)	Amended and Restated 1997 Stock Incentive Plan. Incorporated by reference to Exhibit 10.7 to Form 10-Q filed on November 13, 2006.
10.8(2)	Form of Non-statutory Stock Option Agreement. Incorporated by reference to Exhibit 10.30 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
10.9	Promissory Note, dated August 31, 1997, provided by Harold Dyne to Pacific Trim & Belt, Inc. Incorporated by reference to Exhibit 10.32 to Form SB-2 filed on October 21, 1997, and the amendments thereto.

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- 10.10 Promissory Note, dated October 15, 1997, provided by Harold Dyne to Pacific Trim & Belt, Inc. Incorporated by reference to Exhibit 10.34 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.11 Promissory Note, dated October 15, 1997, provided by A.G.S. Stationary Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.48 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.12 Promissory Note, dated November 4, 1997, provided by Pacific Trim & Belt, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.49 to Form SB-2 filed on October 21, 1997, and the amendments thereto.
- 10.13 Guaranty, dated as of October 4, 2000, by A.G.S. Stationery, Inc. in favor of Mark I. Dyne. Incorporated by reference to Exhibit 10.40 to Form 10-K filed on April 4, 2001.
- 10.14 Guaranty, dated as of October 4, 2000, by Tag-It, Inc. in favor of Mark I. Dyne. Incorporated by reference to Exhibit 10.41 to Form 10-K filed on April 4, 2001.
- 10.15 Guaranty, dated as of October 4, 2000, by Talon International, Inc. in favor of Mark I. Dyne. Incorporated by reference to Exhibit 10.42 to Form 10-K filed on April 4, 2001.
- 10.16 Security Agreement, dated as of October 4, 2000, between A.G.S. Stationery, Inc. and Mark I. Dyne. Incorporated by reference to Exhibit 10.44 to Form 10-K filed on April 4, 2001. Incorporated by reference to Exhibit 10.44 to Form 10-K filed on April 4, 2001.
- 10.17 Security Agreement, dated as of October 4, 2000, between Tag-It, Inc. and Mark I. Dyne. Incorporated by reference to Exhibit 10.45 to Form 10-K filed on April 4, 2001.
- 10.18 Security Agreement, dated as of October 4, 2000, between Talon International Inc. and Mark I. Dyne. Incorporated by reference to Exhibit 10.46 to Form 10-K filed on April 4, 2001.
- 10.19 Security Agreement, dated as of October 4, 2000, between Tag-It Pacific, Inc. and Mark I. Dyne. Incorporated by reference to Exhibit 10.47 to Form 10-K filed on April 4, 2001.
- 10.20 Convertible Secured Subordinated Promissory Note, dated October 4, 2000, provided by Mark I. Dyne to the Registrant. Incorporated by reference to Exhibit 10.48 to Form 10-K filed on April 4, 2001.

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EXHIBIT NUMBER	EXHIBIT DESCRIPTION
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10.21	Form of Investor Rights Agreements dated December 28, 2001. Incorporated by reference to Exhibit 99.4 to Form 8-K filed on January 23, 2002.
10.22	(1) Intellectual Property Rights Agreement, dated April 2, 2002, between the Company and Pro-Fit Holdings, Ltd. Incorporated by reference to Exhibit 10.69 to Form 10-K/A filed on October 1, 2003.

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- 10.23 Common Stock Purchase Warrant dated December 18, 2003 between the Company and Sanders Morris Harris Inc. Incorporated by reference to Exhibit 99.4 to Form 8-K filed on December 22, 2003.
- 10.24 Form of Secured Convertible Promissory Note, dated as of November 9, 2004. Incorporated by reference to Exhibit 10.2 to Form S-3 filed on December 9, 2004.
- 10.25 Form of Common Stock Purchase Warrant, dated as of November 9, 2004. Incorporated by reference to Exhibit 10.3 to Form S-3 filed on December 9, 2004.
- 10.26 Trademark Security Agreement, dated as of November 9, 2004, among the Registrant and the Secured Parties identified on the signature page thereto. Incorporated by reference to Exhibit 10.4 to Form S-3 filed on December 9, 2004.
- 10.27 Registration Rights Agreement, dated as of November 9, 2004, among the Registrant, Sanders Morris Harris Inc. and the Purchasers identified therein. Incorporated by reference to Exhibit 10.5 to Form S-3 filed on December 9, 2004.
- 10.28 Common Stock Purchase Warrant dated as of November 9, 2004, issued by the Registrant in favor of Sanders Morris Harris Inc. Incorporated by reference to Exhibit 10.7 to Form S-3 filed on December 9, 2004.
- 10.29(2) Executive Employment Agreement dated March 16, 2006 between the Registrant and Stephen P. Forte. Incorporated by reference to Exhibit 10.1 to Form 10-Q filed on May 22, 2006.
- 10.30(2) Employment offer letter dated March 16, 2006 between the Registrant and Wouter van Biene. Incorporated by reference to Exhibit 10.2 to Form 10-Q filed on May 22, 2006.
- 10.31(2) Employment offer letter dated March 16, 2006 between the Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.3 to Form 10-Q filed on May 22, 2006.
- 10.32(2) Employment offer letter dated March 16, 2006 between the Registrant and Jonathan Burstein. Incorporated by reference to Exhibit 10.4 to Form 10-Q filed on May 22, 2006.
- 10.33(2) Consulting Agreement dated January 1, 2007 between the Registrant and Jonathan Burstein. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on January 3, 2007.

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EXHIBIT NUMBER	EXHIBIT DESCRIPTION
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14.1	Code of Ethics. Incorporated by reference to Exhibit 14.1 to Form 10-K filed on March 30, 2004.
21.1	Subsidiaries.
23.1	Consent of Singer Lewak Greenbaum & Goldstein LLP.

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- 23.2 Consent of BDO Seidman, LLP.
- 24.1 Power of Attorney (included on signature page).
- 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.

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(1) Certain portions of this agreement have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for an order granting confidential treatment pursuant to Rule 406 of the General Rules and Regulations under the Securities Act of 1933, as amended.

(2) Indicates a management contract or compensatory plan.