

Edgar Filing: TAG IT PACIFIC INC - Form 10-Q

TAG IT PACIFIC INC  
Form 10-Q  
May 15, 2007

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended March 31, 2007.

OR

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 Issuer as Specified in its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

21900 BURBANK BOULEVARD, SUITE 270  
WOODLAND HILLS, CALIFORNIA 91367  
(Address of Principal Executive Offices)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

AT MAY 12, 2007 THE ISSUER HAD 18,541,433 SHARES OF COMMON STOCK, \$.001 PAR VALUE, ISSUED AND OUTSTANDING.

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TAG-IT PACIFIC, INC.  
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| PART I. | FINANCIAL INFORMATION |
| Item 1. | Financial Statements  |

TAG-IT PACIFIC, INC.  
CONSOLIDATED BALANCE SHEETS

|                                 | (Unaudited)<br>March 31,<br>2007 | December 31,<br>2006 |
|---------------------------------|----------------------------------|----------------------|
|                                 | -----                            | -----                |
| Assets                          |                                  |                      |
| Current Assets:                 |                                  |                      |
| Cash and cash equivalents ..... | \$ 3,272,097                     | \$ 2,934,673         |
| Accounts receivable, net .....  | 4,865,809                        | 4,664,766            |
| Note receivable .....           | 1,413,817                        | 1,378,491            |
| Inventories, net .....          | 2,778,331                        | 3,051,220            |

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|   |               |               |
|---|---------------|---------------|
| Recoverable legal costs .....   | 3,302,874     | 107,108       |
| Prepaid expenses and other current assets ...   | 359,097       | 433,926       |
|   | -----         | -----         |
| Total current assets .....  | 15,922,024    | 12,570,184    |
| Property and equipment, net .....   | 5,710,843     | 5,623,040     |
| Fixed assets held for sale .....  | 826,904       | 826,904       |
| Note receivable, less current portion .....   | 1,053,988     | 1,420,969     |
| Due from related parties .....  | 709,822       | 675,137       |
| Other intangible assets, net .....  | 4,110,751     | 4,139,625     |
| Other assets .....  | 355,496       | 437,569       |
|   | -----         | -----         |
| Total assets .....  | \$ 28,759,829 | \$ 25,693,428 |
|   | =====         | =====         |
| Liabilities and Stockholders' Equity  |               |               |
| Current liabilities:  |               |               |
| Accounts payable .....  | \$ 5,222,665  | \$ 4,006,241  |
| Accrued legal costs .....   | 3,518,359     | 427,917       |
| Other accrued expenses .....  | 3,200,025     | 3,359,267     |
| Demand notes payable to related parties .....   | 664,970       | 664,970       |
| Current portion of capital lease obligations .  | 426,879       | 432,728       |
| Current portion of notes payable .....  | 798,324       | 1,107,207     |
| Secured convertible promissory notes .....  | 12,480,512    | 12,472,622    |
|   | -----         | -----         |
| Total current liabilities .....   | 26,311,734    | 22,470,952    |
| Unrecognized tax benefits .....   | 245,800       | --            |
| Capital lease obligations, less current portion   | 374,825       | 474,733       |
| Notes payable, less current portion .....   | 1,074,639     | 1,061,514     |
|   | -----         | -----         |
| Total liabilities .....   | 28,006,998    | 24,007,199    |
|   | -----         | -----         |
| Commitments and contingencies (Note 6)  |               |               |
| Stockholders' Equity:   |               |               |
| Preferred stock Series A, \$0.001 par value;<br>250,000 shares authorized; no shares<br>issued or outstanding .....   | --            | --            |
| Common stock, \$0.001 par value,<br>100,000,000 shares authorized;<br>18,541,433 shares issued and<br>outstanding at March 31, 2007;<br>18,466,433 at December 31, 2006 ..... | 18,541        | 18,466        |
| Additional paid-in capital .....  | 51,900,173    | 51,792,502    |
| Accumulated deficit .....   | (51,165,883)  | (50,124,739)  |
|   | -----         | -----         |
| Total stockholders' equity .....  | 752,831       | 1,686,229     |
|   | -----         | -----         |
| Total liabilities and stockholders' equity .....  | \$ 28,759,829 | \$ 25,693,428 |
|   | =====         | =====         |

See accompanying notes to consolidated financial statements

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### TAG-IT PACIFIC, INC. CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

|  | Three Months Ended March 31, |               |
|--|------------------------------|---------------|
|  | 2007                         | 2006          |
| Net sales .....  | \$ 9,090,117                 | \$ 10,638,216 |
| Cost of goods sold .....                                 | 6,342,923                    | 7,795,491     |
| Gross profit .....                                       | 2,747,194                    | 2,842,725     |
| Selling expenses .....                                   | 706,235                      | 545,625       |
| General and administrative expenses .....                | 2,689,171                    | 2,817,131     |
| Total operating expenses .....                           | 3,395,406                    | 3,362,756     |
| Loss from operations .....                               | (648,212)                    | (520,031)     |
| Interest expense, net .....                              | 147,132                      | 209,372       |
| Loss before income taxes .....                           | (795,344)                    | (729,403)     |
| Provision for income taxes .....                         | --                           | --            |
| Net loss .....   | \$ (795,344)                 | \$ (729,403)  |
| Basic loss per share .....                               | \$ (0.04)                    | \$ (0.04)     |
| Diluted loss per share .....                             | \$ (0.04)                    | \$ (0.04)     |
| Weighted average number of common<br>shares outstanding: |                              |               |
| Basic .....  | 18,533,100                   | 18,241,045    |
| Diluted .....  | 18,533,100                   | 18,241,045    |

See accompanying notes to consolidated financial statements

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### TAG-IT PACIFIC, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

|   | Three Months Ended March 31, |              |
|---|------------------------------|--------------|
|   | 2007                         | 2006         |
| Increase (decrease) in cash and cash equivalents                            |                              |              |
| Cash flows from operating activities:                                       |                              |              |
| Net loss .....  | \$ (795,344)                 | \$ (729,403) |
| Adjustments to reconcile net loss to net cash from<br>operating activities: |                              |              |
| Depreciation and amortization .....   | 377,215                      | 305,304      |

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|  |              |              |
|--|--------------|--------------|
| Increase (decrease) in allowance for doubtful accounts .....                                   | 7,500        | (334,474)    |
| Increase (decrease) in inventory valuation reserves .....                                      | (159,796)    | (2,850,093)  |
| Disposal of asset .....  | --           | 8,502        |
| Stock based compensation .....   | 65,000       | 189,124      |
| Changes in operating assets and liabilities:   |              |              |
| Receivables, including related party .....   | (243,227)    | (242,669)    |
| Inventories .....  | 432,685      | 3,734,521    |
| Recoverable legal costs .....  | (3,195,767)  | --           |
| Prepaid expenses and other current assets ...  | 74,829       | 343,196      |
| Other assets a&othero .....  | 10,016       | (30,429)     |
| Accounts payable and accrued expenses .....  | 1,182,174    | 531,399      |
| Accrued legal expenses .....   | 3,090,442    | 120,672      |
|  | -----        | -----        |
| Net cash from operating activities .....   | 845,727      | 1,045,650    |
|  | -----        | -----        |
| Cash flows from investing activities:  |              |              |
| Acquisition of property and equipment .....  | (356,195)    | (25,148)     |
| Proceeds from sale of equipment .....  | --           | 2,500        |
|  | -----        | -----        |
| Net cash used by investing activities .....  | (356,195)    | (22,648)     |
|  | -----        | -----        |
| Cash flows from financing activities:  |              |              |
| Collection of notes receivable .....   | 331,656      | 20,332       |
| Proceeds from exercise of stock options .....  | 42,750       | --           |
| Repayment of capital leases .....  | (105,756)    | (248,541)    |
| Repayment of notes payable .....   | (420,758)    | (45,567)     |
|  | -----        | -----        |
| Net cash used by financing activities .....  | (152,108)    | (273,776)    |
|  | -----        | -----        |
| Net increase in cash .....   | 337,424      | 749,226      |
| Cash at beginning of period .....  | 2,934,673    | 2,277,397    |
|  | -----        | -----        |
| Cash at end of period .....  | \$ 3,272,097 | \$ 3,026,623 |
|  | =====        | =====        |
| Supplemental disclosures of cash flow information: Cash received (paid) during the period for: |              |              |
| Interest paid .....  | \$ (262,144) | \$ (257,737) |
| Interest received .....  | \$ 75,820    | \$ 36,696    |

See accompanying notes to consolidated financial statements.

TAG-IT PACIFIC, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1. PRESENTATION OF INTERIM INFORMATION

The accompanying unaudited consolidated financial statements have been

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prepared in accordance with accounting principles generally accepted in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited consolidated financial statements reflect all adjustments that, in the opinion of the management of Tag-It Pacific, Inc. and its consolidated subsidiaries (collectively, the "Company"), are considered necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. The results of operations for such periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in the Company's Form 10-K for the year ended December 31, 2006. The balance sheet as of December 31, 2006 has been derived from the audited financial statements as of that date but omits certain information and footnotes required for complete financial statements.

### NOTE 2. EARNINGS PER SHARE

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations:

|  | LOSS         | SHARES     | PER SH<br>AMOU |
|--|--------------|------------|----------------|
| THREE MONTHS ENDED MARCH 31, 2007:                       | -----        | -----      | -----          |
| Basic loss per share:                                    |              |            |                |
| Loss available to common stockholders .....              | \$ (795,344) | 18,533,100 | \$             |
| Effect of Dilutive Securities:                           |              |            |                |
| Options .....  |              | --         |                |
| Warrants .....   |              | --         |                |
| Loss available to common stockholders .....              | \$ (795,344) | 18,533,100 | \$             |
|  | =====        | =====      | =====          |
| THREE MONTHS ENDED MARCH 31, 2006: Basic loss per share: |              |            |                |
| Loss available to common stockholders .....              | \$ (729,403) | 18,241,045 | \$             |
| Effect of Dilutive Securities:                           |              |            |                |
| Options .....  |              | --         |                |
| Warrants .....   |              | --         |                |
| Loss available to common stockholders .....              | \$ (729,403) | 18,241,045 | \$             |
|  | =====        | =====      | =====          |

Warrants to purchase 1,093,813 shares of common stock at between \$3.65 and \$5.06, options to purchase 4,703,135 shares of common stock at between \$0.37 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 three months ended March 31, 2007, but were not included in the computation of diluted loss per share because the effect of exercise or

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conversion would have an antidilutive effect on loss per share.

Warrants to purchase 1,243,813 shares of common stock at between \$3.50 and \$5.06, options to purchase 4,474,635 shares of common stock at between \$0.37 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 three months ended March 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 loss per share.

### NOTE 3. STOCK BASED COMPENSATION

The Company accounts for stock-based awards to employees and directors in accordance with 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. 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".

There were no options granted during the three months ended March 31, 2007. During the three months ended March 31, 2007, a consultant exercised options to acquire 75,000 shares of common stock. Cash received upon exercise was \$42,750 or \$0.57 per share. At the time of exercise, the total intrinsic value of the options exercised was approximately \$72,000 (or \$0.96 per share). Because the option exercised was a non-qualified stock option, the Company will receive a tax deduction for the intrinsic value amount.

During the three months ended March 31, 2006, the Company granted 10-year options to employees and directors to acquire 2,610,135 shares of common stock at a weighted-average exercise price of \$0.42. Options granted were valued using the Black-Scholes option-pricing model at values ranging from \$0.20 to \$0.34 per share. Assumptions used to value the options were: expected term of 5.3 - 6.1 years, expected volatility of 140%, expected annual dividends of zero and a risk-free interest rate of 4.29% - 4.60%.

During the three months ended March 31, 2006, the Company granted two 10 year options to a consultant to acquire a total of 75,000 shares of common stock at \$0.57 per share. An option of 50,000 shares was vested when granted, and an option for 25,000 shares vested on December 31, 2006. The option for 50,000 shares was valued at \$0.56 per share using the following assumptions: expected term of 10 years, expected volatility of 160%, expected dividend rate of zero, and risk-free interest rate of 4.53%. The option for 25,000 shares vesting at December 31, 2006 was also initially valued at \$0.56 per share using the same assumptions, but was revalued each reporting period until vested in accordance with EITF 96-18. During the three months ended March 31, 2006, no options or warrants were exercised.

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The following table summarizes the activity in the Company's share based plans during the three months ended March 31, 2007. At March 31, 2007 the Company may issue additional awards to acquire up to a total of 2,621,477 shares of common stock under the 1997 Plan.

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|   | Number of Shares | Weighted<br>Average<br>Exercise Price |
|---|------------------|---------------------------------------|
|   | -----            | -----                                 |
| EMPLOYEES AND DIRECTORS                                 |                  |                                       |
| Options and warrants outstanding - January 1, 2007 .... | 5,002,635        | \$ 1.41                               |
| Granted .....   | --               | --                                    |
| Exercised .....   | --               | --                                    |
| Cancelled .....   | (299,500)        | \$ 1.03                               |
|   | -----            | -----                                 |
| Options and warrants outstanding - March 31, 2007 ..... | 4,703,135        | \$ 1.44                               |
|   | =====            | =====                                 |
| NON-EMPLOYEES   |                  |                                       |
| Options and warrants outstanding - January 1, 2007 .... | 1,318,813        | \$ 4.13                               |
| Granted .....   | --               | --                                    |
| Exercised .....   | (75,000)         | \$ .57                                |
| Cancelled .....   | (150,000)        | \$ 3.50                               |
|   | -----            | -----                                 |
| Options and warrants outstanding - March 31, 2007 ..... | 1,093,813        | \$ 4.46                               |
|   | =====            | =====                                 |

NOTE 4. INVENTORIES

Inventories are stated at the lower of cost or market value and are all categorized as 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:

|                         | March 31,<br>2007 | December 31,<br>2006 |
|-------------------------|-------------------|----------------------|
|                         | -----             | -----                |
| Finished goods .....    | \$ 3,860,500      | \$ 4,293,220         |
| Less reserves .....     | 1,082,200         | 1,242,000            |
|                         | -----             | -----                |
| Total inventories ..... | \$ 2,778,300      | \$ 3,051,220         |
|                         | =====             | =====                |

NOTE 5. INCOME TAXES

On January 1, 2007 the Company adopted the provisions of Financial Accounting Standards Board 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 and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN



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48 also provides guidance on the recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition associated with income tax liabilities.

As a result of the implementation of FIN 48, the Company recognized an increase in liabilities for unrecognized tax benefits of approximately \$245,800, which was accounted for as an increase in the January 1, 2007 accumulated deficit.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in income tax expense. There was no interest or penalties recognized during the three months ended March 31, 2007 and 2006 for unrecognized tax benefits. At March 31, 2007 the Company had approximately \$33,800 accrued in interest and penalties associated with the unrecognized tax liabilities.

### NOTE 6. CONTINGENCIES AND GUARANTEES

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 on or about April 5, 2007 the Court entered judgment in favor of all defendants. On or about April 30, 2007, plaintiff filed a notice of appeal.

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We believe 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

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reasonably predicted, and an adverse resolution of any of the lawsuit could potentially have a material adverse effect on our financial position and results of operations.

On April 16, 2004 the Company filed suit against Pro-Fit Holdings, Limited ("Pro-Fit") in the U.S. District Court for the Central District of California -- TAG-IT PACIFIC, INC. V. PRO-FIT HOLDINGS, LIMITED, CV 04-2694 LGB (RCx) -- asserting various contractual and tort claims relating to our exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. It is the Company's position that the agreement with Pro-Fit gives us the exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. On September 17, 2004, Pro-Fit filed an answer denying the material allegations of the complaint and filed counterclaims alleging various contractual and tort claims seeking injunctive relief and damages. We filed a reply denying the material allegations of Pro-Fit's pleading. Pro-Fit has since purported to terminate the exclusive license and intellectual property agreement based on the same alleged breaches of the agreement that are the subject of the parties' existing litigation, as well as on an additional basis. On February 9, 2005, and again on June 16, 2005, we amended our pleadings in the litigation to assert additional breaches by Pro-Fit of its obligations under the agreement and under certain additional letter agreements, and for a declaratory judgment that Pro-Fit's patent No. 5,987,721 is invalid and not infringed by us. Thereafter, Pro-Fit filed an amended answer and counterclaims denying the material allegations of the amended complaint and alleging various contractual and tort claims seeking injunctive relief and damages. Pro-Fit further asserted that we infringed its United States Patent Nos. 5,987,721 and 6,566,285. We filed a reply denying the substantive allegations of the amended counterclaims. On June 5, 2006 the Court denied the Company's motion for partial summary judgment holding that summary 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 have historically 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.

A subsidiary, Tag-It de Mexico, S.A. de C.V., has operated under the Mexican government's Maquiladora Program, which entitles Tag-It de Mexico to certain favorable treatment as respects taxes and duties regarding certain imports. In July of 2005, the Mexican Federal Tax Authority asserted a claim against Tag-It de Mexico alleging that certain taxes had not been paid on imported products during the years 2000, 2001, 2002 and 2003. In October of 2005, the Company filed a procedural opposition to the claim and submitted

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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 effect 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.

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In November 2002, the FASB issued FIN No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others - and interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34." The following is a summary of the Company's agreements that it has determined are within the scope of FIN 45:

In accordance with the bylaws of the Company, officers and directors are indemnified for certain events or occurrences arising as a result of the officer or director's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws is minimal and therefore, the Company has not recorded any related liabilities.

The Company enters into indemnification provisions under its agreements with investors and its agreements with other parties in the normal course of business, typically with suppliers, customers and landlords. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by the Company with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities.

### NOTE 7. 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

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framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 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 February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115," ("SFAS No. 159") which expands the use of fair value. Under SFAS No. 159 a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS No. 159 is effective for years beginning after November 15, 2007. We do not believe that SFAS No. 159 will have a material impact on our financial position, results of operations or cash flows.

### NOTE 8. 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

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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:

| Country / Region         | Three Months Ended March 31, |                      |
|--------------------------|------------------------------|----------------------|
| SALES                    | 2007                         | 2006                 |
| United States .....      | \$ 842,500                   | \$ 913,300           |
| Asia .....               | 7,023,300                    | 6,320,400            |
| Mexico .....             | 280,000                      | 1,135,500            |
| Dominican Republic ..... | 385,100                      | 1,640,800            |
| Other .....              | 559,200                      | 628,200              |
|                          | \$ 9,090,100                 | \$10,638,200         |
|                          | =====                        | =====                |
|                          | March 31,<br>2007            | December 31,<br>2006 |
|                          | -----                        | -----                |
| LONG-LIVED ASSETS:       |                              |                      |
| United States .....      | \$ 9,595,700                 | \$ 9,531,659         |
| Asia .....               | 408,100                      | 386,516              |
| Mexico .....             | 3,700                        | 5,078                |
| Dominican Republic ..... | 641,000                      | 668,067              |
|                          | -----                        | -----                |

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|              |              |
|--------------|--------------|
| \$10,648,500 | \$10,591,320 |
| =====        | =====        |

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### 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. 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 below. 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.

#### OVERVIEW

The following management's discussion and analysis is intended to assist the reader in understanding our consolidated financial statements. This management's discussion and analysis 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 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 strategically 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 development, design, sampling and sourcing of trim, we expect to achieve higher margins for our trim products,

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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 footprint 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 garments incorporating an expandable waistband. These products are currently produced by several manufacturers for one single brand. In October 2006 our exclusive supply

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contract with this single 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. However, sales to the previous single brand are expected to decline significantly through the next several quarters, 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 be significantly lower for at least the first half of 2007; though we believe our sales of the product will grow significantly from current levels as we market our products to new customers in the coming months.

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 Contingencies and Guarantees (see Note 6 to our unaudited consolidated financial statements), 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 2006 and 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.

### RESULTS OF OPERATIONS

The following table sets forth selected statements of operations data shown as a percentage of net sales for the periods indicated:

|   | THREE MONTHS ENDED MARCH 31, |        |
|---|------------------------------|--------|
|   | 2007                         | 2006   |
| Net Sales .....                           | 100.0%                       | 100.0% |
| Cost of goods sold .....                  | 69.8                         | 73.3   |
|   |                              |        |
| Gross margin .....                        | 30.2                         | 26.7   |
| Selling expenses .....                    | 7.8                          | 5.1    |
| General and administrative expenses ..... | 29.5                         | 26.5   |
|   |                              |        |

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|                      |        |        |
|----------------------|--------|--------|
| Operating loss ..... | (7.1)% | (4.9)% |
|                      | =====  | =====  |

### SALES

For the three months ended March 31, 2007 and 2006, sales by geographic region based on the location of the customer as a percentage of sales:

|                          | THREE MONTHS ENDED MARCH 31, |        |
|--------------------------|------------------------------|--------|
|                          | 2007                         | 2006   |
| United States .....      | 9.3%                         | 8.6%   |
| Asia .....               | 77.3                         | 59.4   |
| Mexico .....             | 3.0                          | 10.7   |
| Dominican Republic ..... | 4.2                          | 15.4   |
| Other .....              | 6.2                          | 5.9    |
|                          | -----                        | -----  |
| Total .....              | 100.0%                       | 100.0% |
|                          | =====                        | =====  |

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Sales for the three months ended March 31, 2007 were \$9.1 million, or \$1.5 million (14.5%) less than sales for the same period in 2006. The net decrease reflects the decline in sales of Tekfit products resulting from the termination in October 2006 of our exclusive contract for this product. Sales in Asia increased for the three months ended March 31, 2007 by approximately \$0.7 million or 11% over the same period in 2006; offset by a decline in sales from Mexico in 2006 that were discontinued or were shifted to Asia in response to the shift of apparel production from Latin America to Asia and other worldwide markets that began in 2004. We responded to these market changes with a restructuring plan implemented in the third quarter of 2005 that included reducing our operations in Mexico and focusing our efforts on the markets in Asia.

### COST OF SALES

Cost of sales for the three months ended March 31, 2007 were \$6.3 million, or 69.8% of sales, as compared to \$7.8 million, or 73.3% of sales, for the same period in 2006. The total reduction in cost of sales for the period of \$1.4 million is primarily the result of improved manufacturing, distribution, and inventory costs of approximately \$0.4 million, and lower costs of approximately \$1.0 million associated with the net volume decline. The cost reductions for the three months ended March 31, 2007 principally reflect the elimination of inventory write-offs recorded in the first quarter of 2006.

### SELLING EXPENSES

Selling expense for the three months ended March 31, 2007 were \$0.7 million, or 7.8% of sales, as compared to \$0.5 million, or 5.1% of sales, for the same period in 2006. The increase in selling costs reflects the costs associated with additional sales employees (approximately \$120,000) and additional marketing and advertising expenses (approximately \$130,000), offset by lower royalty costs and administrative costs (approximately \$90,000) associated with the decline in Tekfit sales.

### GENERAL AND ADMINISTRATIVE EXPENSES

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General and administrative expense for the three months ended March 31, 2007 were \$2.6 million, or 29.5 percent of sales, as compared with \$2.8 million, or 26.5% of sales, for the same period in 2006. The increase in the general and administrative expense as a percentage of sales is principally the result of the lower sales volume in the period. The net reduction in general and administrative costs of \$125,000 results from lower legal costs (\$232,000), lower professional and audit costs (\$63,000), lower share-based compensation costs (\$54,000), and lower administrative costs (\$78,000); partially offset by increases in costs associated with the expansion of the business in Asia, including increased employee and facility costs (\$80,000); and fewer bad debts recoveries (\$222,000).

For the three months ended March 31, 2007 we incurred \$0.9 million in professional, audit and legal fees associated mainly with the completion of our year-end audit, and in litigation expenses associated with our Pro-Fit license. These costs represent a decrease of \$0.3 million over the comparable costs in the same period of 2006. During the three months ended March 31, 2007 the share-based compensation costs associated with the implementation of FAS 123R was \$65,000 as compared with \$119,000 for the same period in 2006. For the three months ended March 31, 2007 general and administrative expenses were net of \$10,000 in net recoveries of bad debts, and for the three months ended March 31, 2006 general and administrative expenses were net of \$233,000 in net bad debt recoveries.

### INTEREST EXPENSE

Interest expense decreased by approximately \$60,000 to \$147,000 for the three months ended March 31, 2007, as compared to the same period in 2006 due to lower borrowings under certain notes, net of increased interest earnings on our note receivable.

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### INCOME TAXES

There was no provision for income taxes for the three months ended March 31, 2007 or 2006 due to the operating losses incurred and no benefit for income taxes has been recorded since there is not sufficient evidence to determine that we will be able to utilize our net operating loss carry-forwards to offset future taxable income.

### LIQUIDITY AND CAPITAL RESOURCES

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

|                                 | March 31,<br>2007 | December 31,<br>2006 |
|---------------------------------|-------------------|----------------------|
|                                 | -----             | -----                |
| Cash and cash equivalents ..... | \$ 3,272          | \$ 2,935             |
| Total assets .....              | 28,760            | 25,694               |
| Current debt .....              | 26,312            | 22,471               |
| Non-current debt .....          | 1,449             | 1,536                |
| Stockholders' equity .....      | 753               | 1,686                |

### CASH AND CASH EQUIVALENTS

Cash and cash equivalents increased by \$337,000 at March 31, 2007 as compared to December 31, 2006, principally due to cash generated by operating



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activities and lower cash used in financing activities, net of increases in capital expenditures.

Cash provided by operating activities is our only recurring source of funds, and was approximately \$0.8 million for the three months ended March 31, 2007. The cash provided by (used by) operating activities during the three months resulted principally from:

|  |              |
|--|--------------|
| Net loss before non-cash expenses .....                | \$ (353,000) |
| Inventory reductions, net of reserves .....            | 273,000      |
| Receivable increases, net of reserves .....            | (236,000)    |
| Increase in accounts payable and accrued expense ..... | 1,182,000    |
| Other .....  | (20,000)     |
|  | -----        |
|  | \$ 846,000   |

Net cash used in investing activities for the three months ended March 31, 2007 was \$356,000 as compared to \$23,000 for the three months ended March 31, 2006. These expenditures were principally associated with leasehold improvements in new facilities, office equipment for new employees, improvements in our technology systems and a marketing website acquisition. The cash used in the first quarter of 2006 represents capital expenditures for replacement computer equipment.

Net cash used in financing activities for the three months ended March 31, 2007 was approximately \$152,000 and primarily reflects the repayment of borrowings under capital leases and notes payable, net of collections under our note receivable and funds raised from the exercise of stock options. For the three months ended March 31, 2006 the cash used by financing activities was \$274,000 and represented the repayment of notes payable and capital leases, partially offset by our note receivable payments.

Accrued legal costs at March 31, 2007 of \$3.5 million principally reflects amounts due in from our defense of the Class Action compliant filed against us in October 2005, (See Note 6 for more discussion of this litigation). The recoverable legal costs of \$3.3 million at March 31, 2007 reflects contractual and anticipated reimbursements from our insurance carriers associated with this litigation.

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We currently satisfy our working capital requirements primarily through cash flows generated from operations. As the major 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.

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 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

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various financial and investment institutions. We believe we will be successful in completing a modification or replacement of these notes prior to their maturity.

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 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 the 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 March 31, 2007 and the effects such obligations are expected to have on liquidity and cash flow in future periods:

| Contractual Obligations   | Payments Due by Period |                     |              |              |                  |
|---------------------------|------------------------|---------------------|--------------|--------------|------------------|
|                           | Total                  | Less than<br>1 Year | 1-3<br>Years | 4-5<br>Years | After<br>5 Years |
| Demand notes payable      |                        |                     |              |              |                  |
| to related parties(1)     | \$ 1,197,600           | \$ 1,197,600        | \$ --        | \$ --        | \$ --            |
| Capital lease obligations | \$ 902,600             | \$ 493,000          | \$ 409,600   | \$ --        | \$ --            |
| Operating leases .....    | \$ 1,342,800           | \$ 448,000          | \$ 878,000   | \$ 16,800    | \$ --            |
| Notes payable .....       | \$ 2,114,600           | \$ 882,700          | \$ 619,500   | \$ 612,400   | \$ --            |
| Convertible notes payable | \$12,958,200           | \$12,958,200        | \$ --        | \$ --        | \$ --            |
| Total Obligations ..      | \$18,515,800           | \$15,979,500        | \$ 1,907,100 | \$ 629,200   | \$ --            |
|                           | =====                  | =====               | =====        | =====        | =====            |

- (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 March 31, 2007.

At March 31, 2007 and 2006, 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

A director and significant shareholder of Tarrant Apparel Group is also a significant shareholder of the Company. Sales to Tarrant for the three months ended March 31, 2007 were \$100, and sales to Tarrant for the three months ended March 31, 2006 were \$25,300. As of March 31, 2007 and December 31, 2006 there were no amounts due from Tarrant.

Colin Dyne, a director and significant stockholder of the Company is also a significant shareholder in People's Liberation, Inc. During the three months ended March 31, 2007 and 2006, we had sales of \$141,800 and \$15,500, respectively, to subsidiaries of People's Liberation, Inc. At March 31, 2007, accounts receivable included \$104,400 outstanding from People's Liberation subsidiaries. At December 31, 2006, accounts receivable of \$83,400 were outstanding from subsidiaries of People's Liberation, Inc.

Due from related parties at March 31, 2007 includes \$709,800 and at December 31, 2006, \$675,100 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 March 31, 2007 and at December 31, 2006 was \$665,000.

Consulting fees paid to Diversified Investments, a company owned by Mark Dyne, amounted to \$37,500 for the three months ended March 31, 2007 and 2006.

Consulting fees of \$68,750 were paid for services provided by Colin Dyne for the three months ended March 31, 2007 and 2006. Consulting fees of \$73,400 were paid for services provided by Jonathan Burstein, a Director for the three months ended March 31, 2007.

#### 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

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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 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.

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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

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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.

- 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.
  
- 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.

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- 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

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closure activities. We review the status of restructuring activities on a quarterly basis and, if appropriate, records changes based on updated estimates.

- 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 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.

### 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, 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 February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115," ("SFAS No. 159") which expands the use of fair value. Under SFAS No. 159 a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS No. 159 is effective for years beginning after November 15, 2007. We do not believe that SFAS No. 159 will have a material impact on our financial position, results of operations or cash flows.

### CAUTIONARY STATEMENTS AND 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 Part II, Item 1, "Legal Proceedings" for discussion of this litigation. We

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have derived 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 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 effect 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. Sales of this product to Levi are expected to end during the second 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 several 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.

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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 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.

WE MAY NOT BE ABLE TO COLLECT OUR NOTE RECEIVABLE. 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 from Azteca at March 31, 2007 of \$2.5 million 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 predicted at this time. The failure to collect payments under this note as scheduled could have a material adverse effect on our financial position, results of operations and cash flow. At March 31, 2007 Azteca had met all payment requirements under the note as scheduled.

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



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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;

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- o The loss or addition of a major customer;
- o The availability and pricing of materials for our products;
- o The increased expenses incurred in connection with the introduction of new products;
- 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 Part II, Item 1, "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 EFFECT 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 effect 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.

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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.

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

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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:

- 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

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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.

THE REQUIREMENTS OF THE SARBANES-OXLEY ACT, INCLUDING SECTION 404, ARE BURDENSOME, AND OUR FAILURE TO COMPLY WITH THEM COULD HAVE A MATERIAL ADVERSE AFFECT ON OUR BUSINESS AND STOCK PRICE. Effective internal control over financial reporting is necessary for us to provide reliable financial reports and effectively prevent fraud. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate and report on our internal control over financial reporting beginning with our annual report on Form 10-K for the fiscal year ending December 31, 2007. Our independent registered public accounting firm will need to annually attest to our evaluation, and issue their own opinion on our internal control over financial reporting beginning with our annual report on Form 10-K for the fiscal year ending December 31, 2008. We are preparing for compliance with Section 404 by strengthening, assessing and testing our system of internal control over financial reporting to provide the basis for our report. The process of strengthening our internal control over financial reporting and complying with Section 404 is expensive and time consuming, and requires significant management attention. Failure to implement required controls, or difficulties encountered in their implementation, could cause us to fail to meet our reporting obligations. If we or our auditors discover a material weakness in our internal control over financial reporting, the disclosure of that fact, even if the weakness is quickly remedied, could diminish investors' confidence in our financial statements and harm our stock price. In addition, non-compliance with Section 404 could subject us to a variety of administrative sanctions, including the suspension of trading, ineligibility for listing on one of the national securities exchanges, and the inability of registered broker-dealers to make a market in our common stock, which would further reduce our stock price.

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 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

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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.

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 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.

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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

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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 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.

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### ITEM 3. 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 yuans and British pounds. There were no hedging contracts outstanding as of March 31, 2007 or December 31, 2006. Currency 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 March 31, 2007 none of our indebtedness was subject to interest rate fluctuations.

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### ITEM 4. 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 March 31, 2007, 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 March 31, 2007, our disclosure controls and procedures were effective at a reasonable assurance level.

#### CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING

There were no significant changes in our internal controls over financial reporting that occurred during the first quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### PART II

#### OTHER INFORMATION

### ITEM 1. 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

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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 our company's financial situation and our relationship with certain of our 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. We 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 our and the other defendants' motion for summary judgment, and on or about April 5, 2007 the Court entered judgment in favor of all defendants. On or about April 30, 2007, plaintiff filed a notice of

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appeal. We believe 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, 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 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

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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 historically derived 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.

We currently have pending a number of other claims, suits and complaints that arise in the ordinary course of its business. We believe that we has 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 1A. RISK FACTORS

A restated description of the risk factors associated with the Company is included under "Cautionary Statements and Risk Factors" in Management's Discussion and Analysis of Financial Condition and Results of Operations," contained in Item 2 of Part I of this report. This description includes any material changes to and supersedes the description of the risk factors associated with an investment in the Company previously disclosed in our Annual Report on Form 10-K for 2006 and is incorporated herein by reference.

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### ITEM 6. EXHIBITS

- 10.33(1) Consulting Agreement dated January 1, 2007 by and between Tag-It Pacific, Inc. and Jonathan Burstein. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on January 4, 2007.
- 10.34(1) Consulting Agreement effective April 1, 2007 by and between Tag-It Pacific, Inc. and Colin Dyne.
- 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.

(1) Indicates a management contract or compensatory plan.

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SIGNATURES

Pursuant to the requirements 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.

Dated: May 15, 2007

TAG-IT PACIFIC, INC.

/S/ LONNIE D. SCHNELL

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By: Lonnie D. Schnell  
Its: Chief Financial Officer