

**ALLIANCE MEDIA HOLDINGS INC.
AND SUBSIDIARIES**

Consolidated Financial Statements

June 30, 2017

**ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
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INDEPENDENT AUDITOR'S REPORT

To the Stockholders
Alliance Media Holdings Inc.
and Subsidiaries

We have audited the accompanying consolidated financial statements of Alliance Media Holdings Inc. (formerly Alliance Distributors Holding Inc.) and Subsidiaries, which comprise the consolidated balance sheets as of June 30, 2017 and 2016, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Alliance Media Holdings Inc. (formerly Alliance Distributors Holding Inc.) and Subsidiaries as of June 30, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Mayer Hoffman McCann CPAs

October 26, 2017



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ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2017 and 2016
(In thousands, except per share amounts)

	<u>2017</u>	<u>2016</u>
ASSETS		
CURRENT ASSETS:		
Cash and equivalents	\$ 492	\$ 253
Accounts receivable-net	1,181	2,983
Inventory	8,766	11,638
Advances to suppliers and videogame developers	208	636
Prepaid expenses and other current assets	661	333
Deferred income taxes	<u>83</u>	<u>537</u>
Total current assets	11,391	16,380
PROPERTY AND EQUIPMENT – NET	29	61
DEFERRED INCOME TAXES	38	201
OTHER ASSETS	<u>116</u>	<u>136</u>
TOTAL	<u>\$11,574</u>	<u>\$16,778</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Asset-based revolving loan – bank	\$3,244	\$6,754
Accounts payable	1,089	1,153
Accrued expenses and other current liabilities	<u>727</u>	<u>640</u>
Total current liabilities	<u>5,060</u>	<u>8,547</u>
LONG-TERM OBLIGATIONS	<u>-</u>	<u>75</u>
DEFERRED RENT	<u>6</u>	<u>5</u>
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Series A Convertible Non-Redeemable Preferred Stock, \$.001 par value; 8,269 shares authorized; none issued and outstanding	-	-
Common stock, \$.001 par value; 100,000 shares authorized; 44,157 shares issued and outstanding	44	44
Additional paid-in capital	4,034	3,850
Retained earnings	<u>2,430</u>	<u>4,257</u>
Total stockholders' equity	<u>6,508</u>	<u>8,151</u>
TOTAL	<u>\$11,574</u>	<u>\$16,778</u>

See notes to consolidated financial statements.

ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED JUNE 30, 2017 and 2016
(In thousands, except per share amounts)

	<u>2017</u>	<u>2016</u>
NET SALES	\$36,717	\$53,659
COST OF SALES	<u>32,190</u>	<u>46,722</u>
GROSS PROFIT	4,527	6,937
OPERATING COSTS AND EXPENSES	<u>5,955</u>	<u>6,121</u>
INCOME FROM OPERATIONS	(1,428)	816
Interest expense	<u>241</u>	<u>305</u>
(LOSS) INCOME BEFORE PROVISION FOR INCOME TAXES	(1,669)	511
Provision for income taxes	<u>158</u>	<u>186</u>
NET (LOSS) INCOME	<u>\$ (1,827)</u>	<u>\$ 325</u>
Net (loss) income per share – basic and diluted	<u>\$(0.04)</u>	<u>\$0.01</u>
Weighted-average common shares outstanding – basic	<u>44,157</u>	<u>44,157</u>
Weighted-average common shares outstanding – diluted	<u>44,157</u>	<u>45,254</u>

See notes to consolidated financial statements.

ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED JUNE 30, 2017 and 2016
(In thousands)

	Preferred Stock		Common Stock		Additional	Retained	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Earnings	Stockholders' Equity
Balance, July 1, 2015	-	\$ -	44,157	\$ 44	\$ 3,684	\$ 3,932	\$ 7,660
Stock-based compensation expense	-	-	-	-	166	-	166
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>325</u>	<u>325</u>
Balance, June 30, 2016	-	-	44,157	\$ 44	\$ 3,850	\$ 4,257	\$ 8,151
Stock-based compensation expense	-	-	-	-	184	-	184
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,827)</u>	<u>(1,827)</u>
Balance, June 30, 2017	<u>-</u>	<u>\$ -</u>	<u>44,157</u>	<u>\$ 44</u>	<u>\$ 4,034</u>	<u>\$ 2,430</u>	<u>\$ 6,508</u>

See notes to consolidated financial statements.

ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2017 and 2016
(In thousands)

	<u>2017</u>	<u>2016</u>
OPERATING ACTIVITIES:		
Net (loss) income	\$ (1,827)	\$ 325
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Depreciation and amortization	71	61
Stock-based compensation expense	184	166
Amortization of deferred financing costs included in interest expense	6	6
Other	11	(18)
Deferred income taxes	617	(16)
Changes in operating assets and liabilities:		
Accounts receivable	1,792	1,965
Inventory	2,872	2,995
Advances to suppliers and videogame developers	428	(636)
Prepaid expenses and other assets	(329)	(145)
Accounts payable	(64)	(5,135)
Accrued expenses and other current liabilities	<u>(3)</u>	<u>90</u>
Net cash provided by (used in) operating activities	<u>3,758</u>	<u>(342)</u>
INVESTING ACTIVITIES:		
Purchase of property and equipment	<u>(9)</u>	<u>(18)</u>
Net cash used in investing activities	<u>(9)</u>	<u>(18)</u>
FINANCING ACTIVITIES:		
Proceeds from asset-based revolving loan – bank, net of repayments	-	266
Payment of asset-based revolving loan – bank, net of proceeds	<u>(3,510)</u>	<u>-</u>
Net cash (used in) provided by financing activities	<u>(3,510)</u>	<u>266</u>
NET INCREASE (DECREASE) IN CASH AND EQUIVALENTS	239	(94)
CASH AND EQUIVALENTS, BEGINNING OF YEAR	<u>253</u>	<u>347</u>
CASH AND EQUIVALENTS, END OF YEAR	<u>\$ 492</u>	<u>\$ 253</u>

See notes to consolidated financial statements.

ALLIANCE MEDIA HOLDINGS INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

Note 1 - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Alliance Media Holdings Inc. is a publisher and distributor of video game consoles, peripherals, accessories and software to customers throughout the United States for most key manufacturers and third-party publishers in the video game industry. Alliance publishes and develops console and downloadable video games as Alliance Digital Media and Zachtronics through its wholly-owned subsidiary, Alliance Metaversal Studio LLC. The consolidated financial statements include the accounts of Alliance and its wholly-owned subsidiaries (collectively, the “Company”). All significant intercompany accounts and transactions have been eliminated in consolidation.

In May 2016, the Company acquired the video game assets of Zachtronics LLC, an independent video game development studio based in Redmond, Washington.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates reflected in these financial statements relate primarily to allowance for doubtful accounts, reserves for slow-moving or aged inventory and the realization of deferred tax assets.

Cash and Equivalents

For financial statement purposes (including cash flows), the Company considers all highly liquid instruments purchased with an original maturity of three months or less to be cash equivalents.

Allowance for Doubtful Accounts

The Company establishes credit terms for new clients based upon management’s review of their credit information and projects terms, and performs ongoing credit evaluations of its customers, adjusting credit terms when management believes appropriate based upon payment history and an assessment of their current creditworthiness. The Company records an allowance for doubtful accounts for estimated losses resulting from the inability of its clients to make required payments. The Company determines this allowance by considering a number of factors, including the length of time trade accounts receivable are past due, previous loss history, estimate of the client’s current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. While credit losses have generally been within expectations and the provisions established, the Company cannot guarantee that credit loss rates in the future will be consistent with those experienced in the past. In addition, the Company has credit exposure if the financial condition of one of its major clients were to deteriorate. In the event that the financial condition of its clients were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be necessary. It is reasonably possible that the Company’s estimate of the allowance for doubtful accounts will change. As of June 30, 2017 and 2016, the Company’s allowance for doubtful accounts totaled approximately \$15,000 and \$13,000, respectively.

Inventory

Inventory consists entirely of finished goods held for sale and is reported at the lower of cost or market, on the average cost basis. The Company receives price protection from certain of its suppliers for merchandise that may be slow-moving or aged. The Company evaluates the adequacy of its slow-moving or aged inventory quarterly and writes down its inventory to fair value based upon the price protection received or current market value. While write-downs have been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same level of write-downs as in the past. At times, the Company makes advance payments to vendors to procure and ensure delivery of certain high demand products. Such deposits are reflected as advances to suppliers and videogame developers in the consolidated balance sheets. The Company does not offer warranties to its customers but will accept returns of product claimed to be defective and reimburse the customers for the purchase price paid. The majority of the Company’s suppliers in turn accept these returns by customers. There are no reserves for warranties as of June 30, 2017 and 2016. At June 30, 2017 and 2016, there was \$319,000 and \$270,000, respectively, of inventory in-transit.

Property and Equipment

Property and equipment is recorded at cost. Expenditures for major additions and improvements are capitalized and minor replacements, maintenance and repairs are charged to expense as incurred. Leasehold improvements are amortized over the lesser of the lease terms or the assets' useful lives. When property and equipment is retired or otherwise disposed of, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the results of operations for the respective period. Depreciation and amortization is provided over the estimated useful lives of the related assets using the straight-line method.

The estimated useful lives for significant property and equipment categories are as follows:

Leasehold improvements	up to 4 years
Computers, office equipment and furniture	2 to 7 years
Computer software	2 to 3 years
Vehicles	4 years

Software Development Costs

Capitalized software development costs include direct costs incurred for internally-developed titles and payments made to third-party software developers under development agreements.

Internal software development costs, third-party production and other content costs are capitalized subsequent to establishing technological feasibility of a software title. Technological feasibility of a product encompasses both technical design documentation and game design documentation, or the completed and tested product design and working model. Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis.

The Company enters into agreements with third-party independent developers that require it to make payments for game development and production services. In exchange for such payments, the Company receives publishing and distribution rights to the finished game title as well as, in some cases, a portion of the underlying intellectual property rights. Such agreements typically allow for the recovery of these payments to the developers at an agreed-upon royalty rate earned on the subsequent sales of such software, net of any agreed-upon costs. Prior to establishing technological feasibility of a product, costs incurred by third-party developers are reflected as research and development expenses. Subsequent to establishing technological feasibility of a product, development and production service payments to third-party developers are capitalized as software development costs and licenses. The Company typically enter into agreements with third-party developers in the advanced stages of development, after the technical design documentation for a game is either completed or near completion so that the establishment of technological feasibility has generally been accomplished prior to or very soon after contracting with the developer.

Amortization of capitalized software development costs and licenses commences when a product is released and is recorded on a title-by-title basis in cost of goods sold. For capitalized software development costs, amortization is calculated using (1) the proportion of current year revenues to the total revenues expected to be recorded over the life of the title or (2) the straight-line method over the remaining estimated useful life of the title, whichever is greater. For capitalized licenses, amortization is calculated as a ratio of (1) current period revenues to the total revenues expected to be recorded over the remaining life of the title or (2) the contractual royalty rate based on actual net product sales as defined in the licensing agreement, whichever is greater.

Management evaluates the remaining future recoverability of capitalized software development costs and licenses on a quarterly basis. Recoverability is primarily assessed based on the actual title's performance. For products that are scheduled to be released in the future, recoverability is evaluated based on the expected performance of the specific products to which the cost or license relates, utilizing criteria including historical performance of similar products developed with comparable technology; market performance of similar titles and general market conditions. When it is determined that the value of the title is unlikely to be recovered by product sales, capitalized costs are charged to cost of sales in the period in which such determination is made.

Royalties and Licenses

Royalty-based obligations with developers for video games which the Company receives publishing and distribution rights, but for which it does not have an ownership interest in the underlying intellectual property, are either paid in advance and capitalized as prepaid royalties or are accrued as incurred and subsequently paid. These royalty-based obligations are generally expensed to cost of sales at the greater of the contractual rate or an effective royalty rate based on the total projected net revenue for contracts with guaranteed minimums. As of June 30, 2017 and 2016, net royalty advances totaled \$39,000 and \$221,000, respectively, and are reflected on the Company's consolidated balance sheet under the caption advances to suppliers and videogame developers.

Each quarter, management also evaluates the expected future realization of the Company's royalty-based assets to determine amounts deemed unlikely to be realized through product sales. When it is determined that the value of the royalty-based asset is unlikely to be recovered by product sales, capitalized costs are charged to cost of sales in the period in which such determination is made.

For the years ended June 30, 2017 and 2016, royalty expense, including amortization of non-recoupable advances, totaled approximately \$490,000 and \$131,000, respectively, and is included in cost of sales.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. The Company assesses its assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the asset and records impairment losses when this amount is less than the carrying amount. Impairment losses are recorded for the excess of the assets' carrying amount over their fair value, which is generally determined based on the estimated future discounted cash flows over the remaining useful life of the asset using a discount rate determined by management at the date of the impairment review. Management believes at this time that the carrying value and useful life of long-lived assets continue to be appropriate.

Deferred Rent

The Company accounts for scheduled rent increases contained in its leases on a straight-line basis over the non-cancellable lease term.

Revenue Recognition

The Company commences revenue recognition when all the following conditions are satisfied: a) there is persuasive evidence of an arrangement; b) the goods have been shipped to the customer or the services have been provided; c) the collection of the fees is reasonably assured; and d) the amount of fees to be paid by the customer is fixed or determinable.

In accordance with the criteria set forth in ASC 985-605, *Revenue Recognition*, the Company generally recognizes a sale of downloadable digital content when the download is purchased by a customer. Revenue for downloadable content sold via third party digital storefronts is recognized as revenue net of the fees retained by the storefront because management has determined that generally the third party is acting as the primary obligor in the sale to the end consumer.

The Company recognizes advertising revenue for advertisements within the downloadable digital content as advertisements are delivered to customers as long as evidence of the arrangement exists, the price is fixed or determinable, and collectability is reasonably assured.

Income Taxes

The Company accounts for income taxes using the liability method, which requires the recognition of deferred tax assets or liabilities for the temporary differences between the financial reporting and tax bases of the Company's assets and liabilities and for tax carryforwards at enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. In addition, valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company establishes accruals for uncertain tax positions taken or expected to be taken in a tax return when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities that have full knowledge of all relevant information. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Favorable or unfavorable adjustment of the accrual for any particular issue would be recognized as an increase or decrease to income tax expense in the period of a change in facts and circumstances.

As of June 30, 2017 and 2016, there are no unrecognized tax benefits, and there have been no income tax related interest or penalties accrued in the years ended June 30, 2017 and 2016. If and when applicable, the Company will report interest expense and penalties related to income tax liabilities as a component of its provision for income taxes. Tax years commencing July 1, 2013 are subject to tax examination.

Operating Costs and Expenses

The Company includes shipping and handling costs in operating costs and expenses. For the years ended June 30, 2017 and 2016, the Company incurred approximately \$400,000 and \$609,000, respectively, of such costs.

Advertising expenses totaling approximately \$24,000 and \$36,000 for the years ended June 30, 2017 and 2016, respectively, are charged to operations in the period in which they are incurred.

Fair Value of Financial Instruments

The carrying amounts of significant financial instruments, which include accounts receivable, accounts payable and accrued expenses, approximated fair value as of June 30, 2017 and 2016 due to their short-term maturities. Borrowings under the financing agreements approximate fair value due to their variable interest rate.

Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the period increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The dilutive effect of the outstanding options is reflected in diluted earnings per share by

application of the treasury stock method.

Options to purchase approximately 2.8 million shares derived from the exercise of stock options were not included in the computation of diluted loss per share for the year ended June 30, 2017 because as a result of the Company's incurring a loss in such year, their effect would have been antidilutive. Options to purchase approximately 2.6 million shares derived from the exercise of stock options were not included in the computation of diluted income per share for the year ended June 30, 2016 because the options' exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive.

The computational components of basic and diluted earnings per share are as follows (shares in thousands):

	<u>2017</u>	<u>2016</u>
<i>Basic:</i>		
Weighted-average shares outstanding and used in the computation of basic net (loss) income per share	44,157	44,157
Net (loss) income per share attributable to common stockholders - basic	<u>\$(0.04)</u>	<u>\$0.01</u>
<i>Diluted:</i>		
Weighted-average shares outstanding and used in the computation of basic net (loss) income per share	44,157	44,157
Dilutive effect of stock options	-	<u>1,097</u>
Shares used in the computation of diluted net income per share	<u>44,157</u>	<u>45,254</u>
Net (loss) income per share attributable to common stockholders - diluted	<u>\$(0.04)</u>	<u>\$0.01</u>

Stock-Based Compensation

The Company recognizes compensation expense for all equity-based compensation awards issued to employees based on the grant date fair value of those awards.

Note 2 - SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Supplemental disclosures of cash flow information (in thousands) are as follows:

	<u>2017</u>	<u>2016</u>
Cash paid during the years ended June 30, 2017 and 2016 for:		
Interest	<u>\$229</u>	<u>\$302</u>
Income taxes	<u>\$ -</u>	<u>\$369</u>

Supplemental disclosure of non-cash investing and financing activities:

In May 2016, the video game assets of Zachtronics LLC. were acquired for contingent consideration totaling \$75,000, which was recorded on the 2016 consolidated financial statements as a long-term obligation.

Note 3 - CONCENTRATIONS OF CREDIT RISK, SIGNIFICANT CUSTOMERS AND SUPPLIERS

Accounts Receivable and Major Customers

Concentrations of credit risk with respect to accounts receivable are limited because a large number of customers make up the Company's customer base, thus spreading the trade credit risk. The Company controls credit risk through credit approvals, credit limits and monitoring procedures. The Company performs credit evaluations of its customers but generally does not require collateral to support accounts receivable. One customer with multiple divisions accounted for

approximately 34% and 50% of the Company's sales for the years ended June 30, 2017 and 2016, respectively. A second customer accounted for 19% of the Company's sales for the year ended June 30, 2017. No other customer accounted for more than 10% of the Company's sales in the fiscal 2017 or 2016 periods. If a significant customer terminates or modifies its relationship with the Company, future results could be materially and adversely affected. Included in accounts receivable at June 30, 2017 are amounts due from two customers totaling approximately \$272,000 and at June 30 2016 are amounts due from one customer totaling approximately \$1.7 million.

Fluctuations in Operating Results and Seasonality

The Company has experienced fluctuations in its operating results as a result of the timing of the introduction of new titles; variations in sales of titles developed for particular platforms; market acceptance of its titles; sequels or enhancements of existing titles; projected and actual changes in platforms; the timing and success of title introductions by its competitors; product returns; changes in pricing policies by the Company and its competitors; order cancellations; and delays in shipment. Sales of various titles are also seasonal, with peak shipments typically occurring in the fourth calendar quarter as a result of increased demand for titles during the holiday season. Annual comparisons of operating results are not necessarily indicative of future operating results.

Major Suppliers

For the years ended June 30, 2017 and 2016, the Company's three largest suppliers in the aggregate accounted for approximately 64% and 50%, respectively, of total purchases, and the ten largest suppliers in the aggregate accounted for approximately 88% and 80%, respectively, of total purchases. If a significant supplier terminates or modifies its relationship with the Company, future results could be materially and adversely affected.

Note 4 - SOFTWARE DEVELOPMENT COSTS

Capitalized software development costs paid to third-party developers wherein the Company also maintains an ownership interest in the underlying intellectual property are reflected on the Company's consolidated balance sheets under the caption prepaid expenses and other current assets. Capitalized software costs for internally-developed software are reflected on the Company's consolidated balance sheets as under the caption other assets. Such costs, stated at cost less accumulated amortization (in thousands), are as follows:

	<u>June 30,</u> <u>2017</u>	<u>2016</u>
Capitalized software development costs paid to third-party developers	\$ 131	\$ 82
Internally-developed capitalized software development costs	<u>90</u>	<u>-</u>
Total	221	82
Less accumulated depreciation and amortization	<u>203</u>	<u>-</u>
	<u>18</u>	<u>\$ 82</u>
Included in other assets	<u>13</u>	<u>-</u>
Included in prepaid expenses and other current assets	<u>\$ 5</u>	<u>\$ 82</u>

Included in cost of sales is amortization expense totaling approximately \$203,000 for the year ended June 30, 2017.

Note 5 - PROPERTY AND EQUIPMENT

Property and equipment stated at cost less accumulated depreciation and amortization (in thousands) consists of the following at June 30, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Leasehold improvements	\$ 38	\$ 38
Computers, office equipment and furniture	231	223
Software	94	94
Vehicles	<u>49</u>	<u>49</u>
Total	412	404
Less accumulated depreciation and amortization	<u>383</u>	<u>343</u>
	<u>\$ 29</u>	<u>\$ 61</u>

Depreciation and amortization expense approximated \$41,000 and \$58,000 for the years ended June 30, 2017 and 2016, respectively.

Note 6 - FINANCING AGREEMENTS

The Company has a \$20 million revolving loan facility with PNC Bank, NA (the "PNC Facility") expiring on May 31, 2020. Borrowings under the revolving loan facility are based on eligible inventory and receivables, and accrue interest based on either the bank's alternate base rate (as defined) or the Eurodollar rate plus 2.5%. The revolving loan facility is also subject to a 0.25% unused facility fee. The PNC Facility is secured by substantially all the assets of the Company and is subject to the Company's compliance with certain financial covenants. In June 2017, the Company amended the PNC Facility to reduce the maximum borrowings on the line from \$25 million to \$20 million, and amended certain of its financial covenants. At June 30, 2017, the Company was in compliance with the amended covenants. The Company projects compliance with its amended covenants throughout the fiscal 2018 year. In the event compliance is not achieved, the Company believes it can obtain a waiver or modification of the covenant to cure the violation.

At June 30, 2017 and 2016, the interest rate on borrowings outstanding on revolving loans was 3.73% and 3.01%, respectively. Fees totaling \$15,000 paid in 2017 in connection with the loan facility amendment and renewal are being amortized over the remaining term of the facility.

Included in interest expense for the years ended June 30, 2017 and 2016 are amortized financing expenses totaling approximately \$6,000 in each such year.

Note 7 - INCOME TAXES

The components of the provision for (benefit from) income taxes for the years ended June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Current:		
Federal	\$ (433)	\$ 196
State and local	<u>(26)</u>	<u>6</u>
	<u>(459)</u>	<u>202</u>
Deferred:		
Federal	(117)	(14)
State and local	-	(2)
Valuation allowance	<u>734</u>	<u>-</u>
	<u>617</u>	<u>(16)</u>
Total	<u>\$ 158</u>	<u>\$ 186</u>

The Company's effective tax rate for the year ended June 30, 2017 is higher than what would be expected if statutory rates were applied to income principally due the increase in the deferred tax asset valuation allowance.

Significant components of the Company's net deferred tax assets at June 30, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Net operating loss carryforwards	\$ 2,104	\$ 2,104
Reserves and other items not currently deductible	539	485
Equity compensation not currently deductible	240	184
Other	<u>57</u>	<u>50</u>
	2,940	2,823
Less: valuation allowance	<u>(2,819)</u>	<u>(2,085)</u>
Net deferred tax assets	<u>\$ 121</u>	<u>\$ 738</u>
Net deferred tax asset - current	\$ 83	\$ 537
Net deferred tax asset - non-current	<u>38</u>	<u>201</u>
	<u>\$ 121</u>	<u>\$ 738</u>

At June 30, 2017, the Company had federal and state net operating loss carryforwards (NOLs) of approximately \$5.4 million. The federal NOLs expire through 2023. In addition to the NOLs, the Company has other deferred tax assets aggregating \$836,000 at June 30, 2017. In assessing the realization of deferred tax assets, management considers whether it is more likely than not that all or some portion of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the generation of future taxable income during the periods in which temporary differences are deductible and net operating losses are utilized. Based on a consideration of these factors, the Company has established a valuation allowance of approximately \$2,819,000 and \$2,085,000 at June 30, 2017 and 2016, respectively, primarily due to the uncertainty surrounding the Company's ability to generate sufficient future taxable income to realize a portion of the deferred tax assets and the realization of the NOLs that

resulted from a 2004 stock exchange agreement. Pursuant to Internal Revenue Code Section 382 of the Tax Reform Act of 1986 (the “Act”), the utilization of NOLs is limited in the case of certain transactions including significant changes in ownership interests. The Company has determined that based upon the terms of a 2004 stock exchange agreement, an ownership change pursuant to this Act had occurred. As a result, the NOLs are significantly limited. The Company considered many factors when assessing the likelihood of future realization of the deferred tax assets, including the Company’s recent cumulative earnings experience, expectation of future income, and other relevant factors. The valuation allowance was increased by \$734,000 during the year ended June 30, 2017 and was reduced by \$39,000 during the year ended June 30, 2016.

Note 8 - RETIREMENT PLAN

The Company sponsors a 401(k) contributory plan (the “Plan”) for the benefit of employees who are at least 21 years of age. The Company’s management determines, at its discretion, any annual contributions. The Company elected not to contribute to the Plan for the years ended June 30, 2017 and 2016.

Note 9 - STOCK PLANS

In 2015, the Company adopted the 2014 Stock Plan (the “2014 Plan”) to grant equity and equity-linked awards up to a maximum of 6,600,000 shares of common stock. The Company also has a 2004 Stock Plan (the “2004 Plan”) and a 2006 Stock Plan (the “2006 Plan”). Beginning in January 2015 no stock awards may be granted from either of these earlier plans. If stock option grants are exercised, the Company expects to issue shares from its currently authorized common shares.

Information with respect to stock options pursuant to the 2004 Plan and 2014 Plan follows (no stock options have been awarded from the 2006 Plan):

	Shares (in thousands)	Weighted- Average Exercise Price	Weighted-Average Remaining Contractual Term
Outstanding - July 1, 2015	5,720	\$.183	
Granted	1,168	\$.180	
Expired	<u>-</u>		
Outstanding - June 30, 2016	6,888	\$.183	
Granted	250	\$.270	
Expired	<u>(100)</u>	\$.160	
Outstanding - June 30, 2017	<u>7,038</u>	\$.186	6.1 years
Exercisable at June 30, 2017	<u>5,323</u>	\$.184	5.8 years

All the issued options are ten-year non-qualified stock option grants. In fiscal 2017, the Company granted options under the 2014 Plan to purchase a total of 250,000 common shares to certain of its employees which vest ratably in sixteen equal quarterly installments. In fiscal 2016, the Company granted options under the 2014 Plan to purchase a total of 668,000 common shares to its officers and employees and a total of 500,000 common shares to its five independent directors, all of which vest ratably in sixteen equal quarterly installments.

The fair value of the options-pricing model was calculated with the following weighted-average assumptions used: risk-free interest rate - 2.5 % in fiscal 2017 and 2.3% in 2016; expected life- seven years; expected volatility- 80% in fiscal 2017 and 2016. The fair value generated by the options-pricing model may not be indicative of the future benefit, if any, that may be received by the option holder. The total fair value of exercisable stock options at June 30, 2017 is approximately \$707,000.

For the years ended June 30, 2017 and 2016, stock-based compensation expense related to the Company’s Stock Plans totaled approximately \$184,000 and \$166,000, respectively, and is included in operating costs and expenses. In addition, at June 30, 2017, compensation cost related to non-vested stock options not yet recognized totaled approximately \$237,000. This cost is expected to be recognized over a weighted-average period of 2.1 years.

The number and weighted-average grant date fair value of non-vested stock options for the years ended June 30, 2017 and 2016 is as follows:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value
Non-vested - July 1, 2015	2,787	\$.138
Granted	1,168	\$.130
Vested	<u>(1,196)</u>	\$.140
Non-vested - June 30, 2016	2,759	\$.134
Granted	250	\$.200
Vested	<u>(1,295)</u>	\$.142
Non-vested - June 30, 2017	<u>1,714</u>	\$.138

Note 10 - ACQUISITION

In May 2016, the Company acquired the video game assets of Zachtronics LLC, an independent video game development studio based in Redmond, Washington, and hired its four employees. The purchase price consists solely of an annual earn-out payment based upon a percentage of profits earned through June 2023 from completed video games acquired from Zachtronics LLC.

The entire portion of the purchase price has been allocated to videogame software development costs and is included in other assets on the Company's June 30, 2016 consolidated balance sheet. The costs are amortized over their estimated useful life of 30 months. For the years ended June 30, 2017 and 2016, amortization expense totaled \$30,000 and \$2,500, respectively.

The estimated fair value of the contingent consideration was determined based on the Company's estimates using a forecasted cash flow approach. The fair value of the contingent consideration totaling \$75,000 as of June 30, 2017 is included in accrued expenses and other current liabilities since it will be payable within the subsequent twelve months. The fair value of the contingent consideration totaling \$75,000 on June 30, 2016 was recorded on the consolidated financial statements as a long-term obligation. Any subsequent changes in the fair value of the contingent consideration obligations will be recorded in the consolidated income statement.

Note 11 - COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENTS

Leases

The Company leases its offices and warehouse space under operating leases which expire through October 2020. The future minimum lease payments, excluding escalation charges, for leases having a remaining non-cancelable term in excess of one year are shown below:

<u>Operating leases</u>	(in thousands)
Fiscal year ending June 30, 2018	\$290
Fiscal year ending June 30, 2019	286
Fiscal year ending June 30, 2020	134
Fiscal year ending June 30, 2021	<u>35</u>
Total	<u>\$745</u>

For non-cancelable operating leases with scheduled rent increases, the Company recognized rent expense on a straight-line basis over the lease term. Rent expense was increased by approximately \$3,000 in fiscal 2017 and was decreased in fiscal 2016 by approximately \$18,000 resulting from the impact of rent abatements and the amortized portion of scheduled rent increases.

Total rent expense charged to operations for the years ended June 30, 2017 and 2016 was approximately \$338,000 and \$275,000, respectively.

Software Development and Licensing Agreements

The Company has contractual arrangements with third-party developers to develop and/or for the rights to exclusively publish and distribute video games. In certain situations, the Company also maintains an ownership interest in the underlying intellectual property. The payments to third-party developers are generally conditioned upon the achievement by the developers of contractually specified development milestones. Further, these payments to third-party developers typically are advances and, as such, are recoupable against future royalties based on sales of the related game. In certain arrangements, the Company may also commit to spend specified amounts for marketing support for the game(s) which is (are) to be developed. The total future minimum commitments for arrangements in place on June 30, 2017 were not significant.

Employment Agreements

The Company has employment agreements with two executives which provide for annual base compensation, health insurance and other fringe benefits, and contain certain confidentiality and non-compete provisions. Each of the agreements provide that in the event the Company terminates their employment without cause, the Company will pay severance.

In addition, in connection with its acquisition of the assets of Zachtronics LLC, the Company agreed to establish a bonus pool, which provides for the payment of annual bonuses to the employees hired pursuant to the acquisition based upon a percentage of profits earned from games they develop.

Legal Proceedings

The Company is subject to claims and litigation arising in the ordinary course of business. Management does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

Subsequent Events

The Company has evaluated subsequent events through October 26, 2017, which is the date the consolidated financial statements were available to be issued, and has concluded that no events or transactions took place which would require disclosure herein.