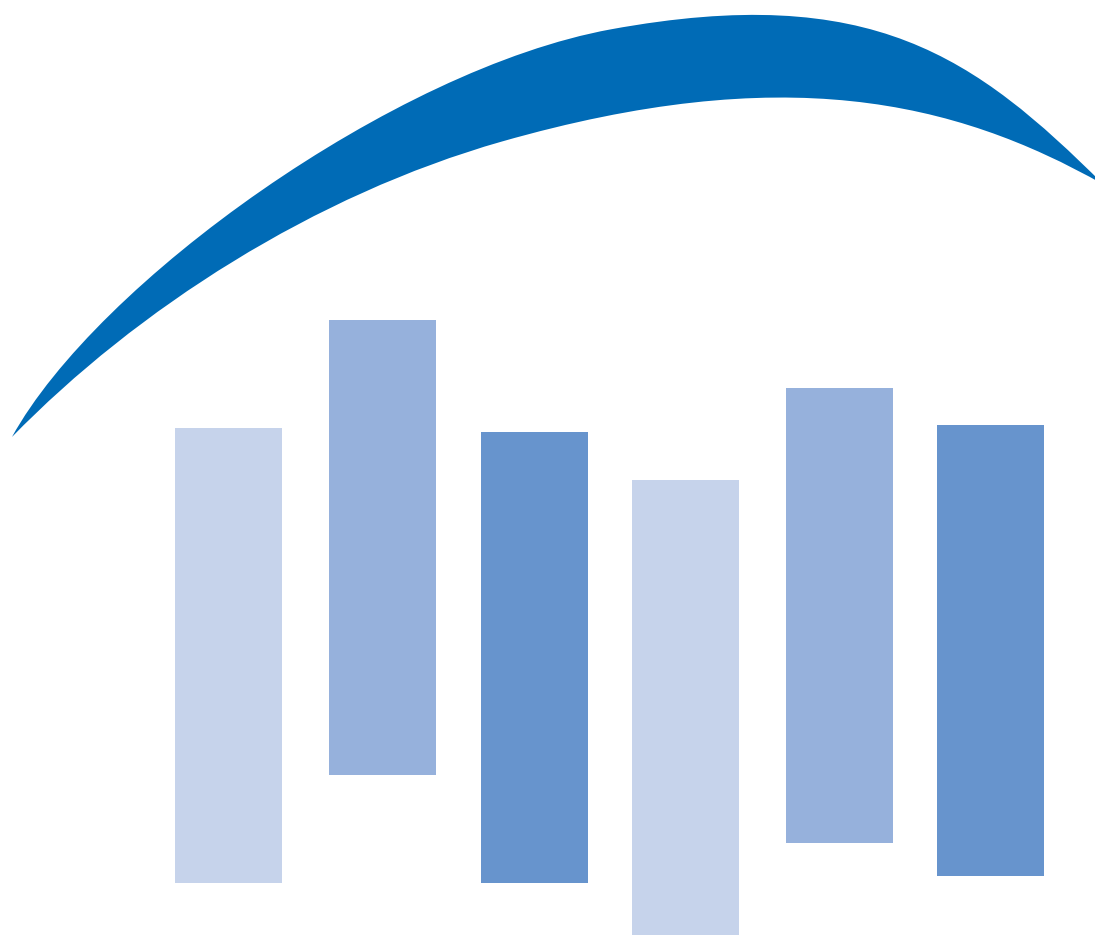




Annual Report

Year Ended December 31, 2006

Trading Symbol: **AUGR.PK**



MANAGEMENT'S DISCUSSION AND ANALYSIS

CRITICAL ACCOUNTING POLICIES

The Company maintains its accounting books and records in accordance with accounting principles generally accepted in the United States of America. The preparation of the financial statements of the Company in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and sales and expenses during the reporting period. These estimates are based on information available as of the date of the financial statements. Actual results may materially differ from those estimated. The Company's critical accounting policies include the following:

- Capitalized software development costs
- Amortization of software development costs
- Revenue recognition

The Company accounts for internally developed software in accordance with Statement of Financial Accounting Standard (SFAS) No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed." The Company collects and segregates software development labor hours applied to design, development, quality assurance and product documentation associated with the software development process. All labor hours associated with the design and specification development process are expensed as incurred until a detailed design has been developed. All labor hours associated with coding, debugging, alpha testing, software bug corrections, quality assurance testing and documentation are eligible for capitalization under SFAS No. 86. Generally, the Company capitalizes approximately 70% of eligible costs based on an average actual cost per labor hour and charges the balance to research and development expense. On an annual basis, the Company evaluates its capitalized software for recoverability against the estimated future revenues over the next five years from the products or services. To the extent that more development costs are capitalized, the Company's net income will improve, and, to the extent that more software development costs are expensed instead of capitalized, the Company's net income will decline.

The Company amortizes its software development costs in accordance with the estimated economic life of the software, which generally is seven years. The Company's typical product lifecycle has been about 15 years, which was true for its prior film/fiche product line, CD-ROM product line and current Internet/Web product line, which has now been deployed for 13 years and is still growing. To the extent the actual useful life varies significantly from the estimated useful life, amortization expense may be understated or overstated. Generally, amortization expense averages approximately 13% of total sales.

The Company recognizes revenue in accordance with the American Institute of Certified Public Accountant's Statement of Position ("SOP") 97-2, "Software Revenue

Recognition", as amended by SOP 98-4 and SOP 98-9 and Emerging Issues Task Force ("EITF") Issue No. 00-3, "Application of AICPA SOP 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware" and EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." The SOP provides that revenue may be recognized when persuasive evidence of an agreement (contract or purchase order) exists, delivery has occurred, the price is fixed or readily determinable and collectability is probable with some exceptions.

Revenue recognition policies vary according to the nature of the revenue. The Company's primary revenue stream is outsourced web hosting services, which are sold on a subscription basis. Generally, these large contract services are billed in advance on an annual, semi-annual or quarterly basis. Revenue is then recognized monthly as services are rendered. Revenues, which have been billed, and payment collected in advance are booked as deferred revenue until the services are provided and revenues earned. For certain small annual subscriptions, one-fourth of the annual revenue is recognized in the quarter the annual subscription is billed (or renews) and the balance is recognized evenly over the next three quarters in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended by SOP 98-4 and 98-9 as noted in footnote 1 to the financial statements. Certain contract job processing services are progress billed and revenues recognized as the processing services are performed on a monthly basis. Certain software and hardware sales are billed when the product is shipped or access rights are provided to the customer. Certain revenue transactions may include multiple deliverables, which may or may not be separately priced. For deliverables which are not separately priced, the Company uses the relative fair values of the separate deliverables to allocate revenues. Each deliverable is then treated in accordance with the above revenue recognition policies depending on the nature of the deliverable.

Liquidity and Capital Resources

Working capital declined by \$409,000 to working capital deficit of \$342,000 in 2006 down from \$67,000 in 2005 due primarily to the commitment to purchase stock from a retired director in 2007. The cash flow from operations of \$1,721,000 enabled the Company to fund \$568,000 in capital expenditures internally, purchase common stock of \$1,048,000 and increase cash by \$105,000 to \$880,000 in 2006. The Company's excess cash is invested in uninsured investment grade securities on a short-term basis. (See Note 1 of Notes to Consolidated Financial Statements).

The Company's primary AGent™ product is sold on an annual subscription basis with fees for services billed to the customer and paid annually or quarterly in advance. These cash payments are received and booked to deferred revenue on the balance sheet to be applied as the monthly sales revenues are earned and recognized on a pro-rata basis. A growing percentage of sales (approximately 65%) of the Company's sales revenues are now being paid through customer advances without ever flowing through accounts receivable. Therefore, the average accounts receivable balance is lower than it would

otherwise historically be and there is a substantial deferred revenue balance in current liabilities representing revenues to be earned from future services for customers who have paid in advance.

At December 31, 2006, the Company's principal financial commitments, other than its bank line of credit, involved the lease of corporate facilities in Pomona, California and in Toronto, Canada. Total commitments over the next six years total approximately \$1,675,000. (See Note 4 of Notes to Consolidated Financial Statements).

The Company's principal use of cash for investing activities during 2006 and 2005 were directed primarily towards continuing development of the Company's AGent™ and VERSO™ software and ASP (Application Service Provider) services. The Company invested \$935,000 in 2006 and \$1,122,000 in 2005 in software development of which \$465,000 and \$567,000 was capitalized in 2006 and 2005 respectively. The remainder of investing activities was to acquire hardware and software used to expand and enhance online services to the Company's current and prospective ASP customers. Total capital expenditures and investments were \$103,000 in 2006 up from \$94,000 in 2005.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been reported in the Company's financial statements or tax returns. The valuation allowance at December 31, 2006 and 2005 reflects an unrecognized U.S. and foreign tax loss carryforward. At December 31, 2006, the Company had available net operating loss carryforwards of \$2,552,000 for federal income tax purposes, \$1,139,000 for state income tax purposes and \$49,000 for foreign income tax purposes. These net operating loss carryforwards expire from 2020 to 2024 for federal taxes, 2012 to 2013 for state taxes, and 2010 to 2013 for foreign taxes.

In August 2006, the bank renewed and extended the Company's credit facility through May 1, 2008. The credit facility is composed of a \$500,000 revolving line of credit for working capital and a second \$1,000,000 five-year term facility to fund major investments. The interest rate on both credit facilities is the bank prime rate (8.25% at December 31, 2006) plus a 1.0% margin or 9.25% at December 31, 2006. The credit facility is secured by all of the assets of the Company and its subsidiary, A-G Canada Ltd. and requires that the Company maintain certain minimum financial covenant ratios. The Company was in compliance with all of its financial loan covenants, there were no outstanding borrowings under either credit facility and there was \$1,500,000 in available credit as of December 31, 2006.

The Company has no so-called special purpose entities or off-balance sheet or derivative financing of any kind. All entities have been consolidated and all material intercompany accounts and transactions have been eliminated.

The Company has focused its resources on its core business of library services and is not soliciting new publishing customers. The Company's strategy is to offer ASP (Application Service Provider) services through outsourced web hosting to its library customers sold on an annual subscription basis. We believe that this is very attractive to

our customers because it eliminates the large upfront capital investment, and ongoing technical management and technical staff requirements that the library would otherwise require and also provides an affordable and predictable monthly budget for the library. With a core of highly competent technical personnel, computer equipment and the Internet/Web, the Company can offer an efficient and very cost effective solution for the library. The majority (approximately 85%) of this subscription business also forms an ongoing stream of recurring business each year under multiple year contracts.

RESULTS OF OPERATIONS

2006 as Compared to 2005

Net sales increased \$180,000 or 3% from \$5,150,000 in 2005 to \$5,331,000 in 2006 due to an increase in implementation and license revenues from new contracts.

Cost of sales increased \$127,000 in 2006 or 10% as a result of additional software amortization and non-recurring variable costs associated with the implementation of a library contract. Cost of sales includes \$838,000 and \$846,000 in non-cash depreciation and amortization in 2006 and 2005, respectively. Gross margins declined to 73% in 2006 from 75% in 2005 due to additional variable costs from outsourced contract related services.

Research and development decreased \$86,000 or 15% from \$555,000 in 2005 to \$470,000 in 2006 due to reductions in staffing and outsourced development costs. Research and development is presented net of capitalized software of \$465,000 in 2006 and \$567,000 in 2005. Gross research and development costs decreased \$187,000 or 17% from \$1,122,000 in 2005 to \$935,000 in 2006 due to completion of several new product development projects.

Sales, marketing and customer service increased \$285,000 or 14% to \$2,295,000 from \$2,010,000 due to additional sales and marketing costs associated with the roll-out of the Company's new AGen Search product and outsourced marketing services.

General and administrative expenses decreased \$177,000 or 18% from \$977,000 in 2005 to \$800,000 in 2006 due to lower legal expenses, corporate development expenses, and allowance for uncollectible accounts.

Operating income increased \$31,000 or 10% to \$337,000 in 2006 versus \$306,000 in 2005 due to an increase in net sales.

Interest expense was zero in 2006 down from \$11,000 in 2005 due to no debt in 2006.

Other income primarily reflects interest income on short-term cash investments of \$35,000 in 2006 up from \$17,000 in 2006 due to higher average cash balances and increasing interest rates.

Provision for taxes based on income reflects minimum state tax payments and the effect of federal and state net operating loss carryforwards (See Note 3 of Notes to Consolidated Financial Statements).

Net income was \$333,000 in 2006 up \$22,000 or 5% from \$311,000 in 2005 due to higher sales and interest income. Basic and diluted earnings per share was \$0.06 in 2006 and \$0.06 and \$0.05, respectively, in 2005.

Stock-based Compensation

Effective January 1, 2006, the Company adopted SFAS No. 123R, "Shared-Based Payment" using the modified prospective application transition method. The modified prospective method applies the expense recognition requirements of SFAS No. 123R to new awards outstanding at the effective date and does not restate prior periods for comparative purposes. The Company applies the Black-Scholes valuation method in determining the fair value of share-based payments to employees, which is then amortized on a straight-line basis over the requisite service period. The adoption of SFAS No. 123R did not have a significant impact on the Company's financial position, results of operations and cash flows. (See Note 6 of the Notes to Consolidated Financial Statements).

Information Relating To Forward-Looking Statements

This Report includes forward-looking statements which reflect the Company's current views with respect to future events and financial performance. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Impact of Inflation

General price inflation is not anticipated to have a material effect on the Company's business in the near future. Historical dollar accounting does not reflect changing costs of operations, the future cost of expansion and the changing purchasing power of the dollar. Should more than moderate inflation occur in the future, it can be expected to impact the Company in an adverse manner, as prices cannot be adjusted quickly due to the contractual nature of a substantial amount of the Company's business, while costs of personnel, materials and other purchases tend to escalate more rapidly.

Foreign Exchange

The functional and reporting currency of the Company is the U.S. dollar, while the functional and reporting currency for A-G Canada Ltd., the Company's wholly owned Canadian subsidiary, is the Canadian dollar. Accordingly, the Company is exposed to foreign currency translation gains or losses as the relationship between the Canadian dollar and United States dollar fluctuates. Increases in the value of the Canadian dollar against the U.S. dollar will result in foreign exchange transaction gains and decreases in the value of the Canadian dollar will result in foreign exchange transaction losses. Other than for sales and expenses by A-G Canada in Canada, all other transactions involving the Company are generally denominated in U.S. dollars. (See Note 1 of Notes to Consolidated Financial Statements).

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders
Auto-Graphics, Inc.
Pomona, California

We have audited the accompanying consolidated balance sheets of Auto-Graphics, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Auto-Graphics, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As required by the following Standard and discussed in Note 6 to the Consolidated Financial Statements, the Company adopted Statement of Financial Accounting Standard No. 123R, Shared-based Payment, effective January 1, 2006.

Swenson Corporation

Rancho Cucamonga, California
March 17, 2007

AUTO-GRAPHICS, INC.
CONSOLIDATED BALANCE SHEETS
December 31, 2006 and 2005

ASSETS	2006	2005
Current assets:		
Cash and cash equivalents (Note 1)	\$ 880,335	\$ 775,460
Accounts receivable, less allowance for doubtful accounts (\$5,000 in 2006 and \$90,000 in 2005) (Note 1)	426,041	229,468
Deferred income taxes – current (Note 3)	58,000	83,000
Other current assets	68,434	69,206
Total current assets	1,432,810	1,157,134
Software, net (Note 1)	2,307,706	2,549,295
Equipment, furniture and leasehold improvements, net (Note 1)	203,562	231,666
Other assets (Note 1)	22,522	65,022
	\$ 3,966,600	\$ 4,003,117
 <u>LIABILITIES & STOCKHOLDERS' EQUITY</u>		
Current liabilities:		
Accounts payable	\$ 51,907	\$ 82,168
Deferred revenue	827,102	735,497
Accrued payroll and related liabilities	200,607	183,870
Other accrued liabilities (Note 6)	694,745	88,346
Total current liabilities	1,774,361	1,089,881
Deferred income taxes (Note 3)	66,000	91,000
Total liabilities	1,840,361	1,180,881
Commitments and contingencies (Note 4)	--	--
Stockholders' equity:		
Common Stock, 12,000,000 shares authorized, 4,297,610 and 5,525,586 shares issued and outstanding in 2006 and 2005, respectively (Note 6)	3,245,700	4,274,625
Accumulated deficit	(1,079,120)	(1,412,048)
Accumulated other comprehensive loss	(40,341)	(40,341)
Total stockholders' equity	2,126,239	2,822,236
	\$ 3,966,600	\$ 4,003,117

See Notes To Consolidated Financial Statements.

AUTO-GRAPHICS, INC.
CONSOLIDATED STATEMENTS OF INCOME
For the years ended December 31, 2006 and 2005

	2006	2005
Net sales		
Subscriptions and maintenance	\$ 4,554,850	\$ 4,527,344
License and services	775,746	623,047
Total net sales	5,330,596	5,150,391
Costs and expenses		
Cost of sales	1,428,975	1,302,407
Research and development	469,872	555,383
Sales, marketing and customer service	2,294,644	2,009,843
General and administrative	800,489	976,535
Total costs and expenses	4,993,980	4,844,168
Income from operations	336,616	306,223
Interest expense, net	--	11,412
Other income	(35,312)	(16,686)
Income before income taxes	371,928	311,497
Income tax expense	39,000	--
Net income	\$ 332,928	\$ 311,497
<u>Earnings per share (Note 1):</u>		
Basic income per share	\$.06	\$.06
Weighted average shares outstanding	5,269,088	5,525,586
Diluted income per share	\$.06	\$.05
Weighted average shares outstanding	5,773,571	5,935,486

See Notes To Consolidated Financial Statements.

AUTO-GRAPHICS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the years ended December 31, 2006 and 2005

	<u>Common Stock</u>		Retained Earnings/ (Accumulated Deficit)	Other Comprehensive Loss	Total Stockholders' Equity
	<u>Shares</u>	<u>Amount</u>			
Balances at December 31, 2004	5,525,586	\$4,274,625	\$ (1,723,545)	\$ (40,495)	\$ 2,510,585
Net income	--	--	311,497	--	311,497
Foreign currency translation adjustments	--	--	--	154	154
Comprehensive income	--	--	--	--	311,651
Balances at December 31, 2005	5,525,586	\$4,274,625	\$ (1,412,048)	\$ (40,341)	\$ 2,822,236
Net income	--	--	332,928	--	332,928
Foreign currency translation adjustments	--	--	--	--	--
Comprehensive income	--	--	--	--	332,928
Common stock purchased or to be purchased	(1,227,976)	(1,047,772)			(1,047,772)
Stock option expense	--	18,847	--	--	18,847
Balances at December 31, 2006	<u>4,297,610</u>	<u>\$3,245,700</u>	<u>\$ (1,079,120)</u>	<u>\$ (40,341)</u>	<u>\$ 2,126,239</u>

See Notes To Consolidated Financial Statements.

AUTO-GRAPHICS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Net income	\$ 332,928	\$ 311,497
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	837,767	845,518
Deferred income taxes	(25,000)	34,000
Provision for doubtful accounts	(85,000)	75,000
Stock option expense	18,847	--
Changes in operating assets and liabilities:		
Accounts receivable	(111,573)	217,453
Other current assets	25,772	37,157
Other assets	42,500	60
Accounts payable	(30,261)	(3,366)
Deferred revenue	91,605	(115,357)
Accrued payroll and related liabilities	16,737	(67,965)
Other accrued liabilities	606,399	(74,781)
Net cash provided by operating activities	1,720,721	1,259,216
Cash flows from investing activities:		
Capital expenditures	(102,626)	(94,322)
Capitalized software development	(465,448)	(566,992)
Net cash used in investing activities	(568,074)	(661,314)
Cash flows from financing activities:		
Common stock purchased	(1,047,772)	--
Proceeds from surrender of keyman life insurance policies	--	100,664
Net cash provided by (used in) financing activities	(1,047,772)	100,664
Net increase in cash	104,875	698,566
Foreign currency effect on cash	--	18,314
Cash at beginning of year	775,460	58,580
Cash at end of year	\$ 880,335	\$ 775,460

See Notes To Consolidated Financial Statements.

AUTO-GRAPHICS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006 and 2005

1. Summary of significant accounting policies.

Auto-Graphics, Inc. (the “Company”), a California corporation incorporated in 1960, including its wholly owned A-G Canada, Ltd. subsidiary provide software products and services used to create, manage, publish and access information content via the Internet/Web.

A-G Canada, a Canadian corporation formed in 1997, provides software products and services to customers in the library community in Canada.

Basis of Presentation

The consolidated financial statements include the accounts of Auto-Graphics, Inc. and it’s wholly and majority-owned subsidiaries. All material intercompany accounts and transactions have been eliminated. Certain disclosures for 2006 may have been changed and disclosure for 2005 has been reclassified to provide comparative information.

Revenue Recognition

The Company recognizes revenue in accordance with the American Institute of Certified Public Accountant's Statement of Position ("SOP") 97-2, "Software Revenue Recognition", as amended by SOP 98-4 and SOP 98-9 and Emerging Issues Task Force (“EITF”) Issue No. 00-3, “Application of AICPA SOP 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity’s Hardware” and EITF Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables.” The SOP provides that revenue may be recognized when persuasive evidence of an agreement (contract or purchase order) exists, delivery has occurred, the price is fixed or readily determinable and collectability is probable with some exceptions.

Recurring revenues for ASP (Application Service Provider) services, database subscriptions and software maintenance and support contracts are recognized as services are rendered on a quarterly pro rata basis over the contractual period commencing in the period in which access rights are provided to the customer.

License revenues are recognized when the software is shipped to the customer or system access rights are provided to the customer.

Revenues for installation, training and other non-recurring services are recognized as services are provided to the customer.

Certain revenue transactions may include multiple deliverables, which may or may not be separately priced. For deliverables which are not separately priced, the Company uses the relative fair values of the separate deliverables to allocate revenues. Each deliverable is then treated in accordance with the above revenue recognition policies depending on the nature of the deliverable.

Revenues for which payment has been received in advance are treated as deferred revenue until services are provided and the revenues have been earned.

Use of Estimates

The preparation of the financial statements of the Company in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and sales and expenses during the reporting period. These estimates are based on information available as of the date of the financial statements. Actual results may materially differ from those estimated.

Foreign Currency Translation

The functional and reporting currency for operations located in Canada is the Canadian dollar. Consequently, assets and liabilities must be translated into U.S. dollars using standard exchange rates and the effects of the foreign currency translation adjustments are accumulated as other comprehensive income and included as a component of stockholders' equity. All other Company transactions are denominated in U.S. dollars.

Credit Risk

The Company performs ongoing credit evaluations of its customers and generally requires cash deposits in advance of providing services. The Company maintains a reserve for potential losses from uncollectible accounts in the form of an allowance for doubtful accounts and actual losses in 2006 and 2005 were in line with management's expectations. The Company may be exposed to credit risk for trade receivables beyond the reserves established by the Company for this purpose. The Company places its cash with high credit quality financial institutions and, at times, the balance may be in excess of the FDIC limit (See Cash and Cash Equivalents).

Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practical to estimate that value:

Cash and Cash Equivalents and Accounts Receivables. The carrying amounts approximate fair value because of the short-term maturity of these instruments.

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Excess cash of approximately \$515,000 and \$300,000 is invested in uninsured short-term investment grade securities as of December 31, 2006 and 2005, respectively.

Accounts Receivables

Accounts receivables are carried at original invoice amount less an estimate made for doubtful receivables based on reviews of outstanding amounts on a regular basis (See Credit Risk).

Unbilled Production Costs

Unbilled Production Costs is included in Other Current Assets on the Consolidated Balance Sheet. Costs associated with work in process (WIP) include: labor, materials, and operations overhead (excluding selling, general and administrative expenses) are stated at the lower of cost or net realizable value, and are removed from WIP inventory on a standard cost basis.

Software, net

Software is recorded at historical cost. Software at December 31, 2006 and 2005, consist of the following:

	<u>2006</u>	<u>2005</u>
Computer software and database	\$ 8,589,168	\$ 8,123,720
Less accumulated amortization	<u>6,281,462</u>	<u>5,574,425</u>
	<u>\$ 2,307,706</u>	<u>\$ 2,549,295</u>

Software capitalization and amortization: Certain costs incurred related to the development and purchase of computer software are capitalized and amortized in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed" ("SFAS

No. 86”). The Company collects and segregates software development labor hours applied to design, development, quality assurance and product documentation associated with the software development process. All labor hours associated with the design and specification development process are expensed as incurred until a detailed design has been developed. All labor hours associated with coding, debugging, alpha testing, software bug corrections, quality assurance testing and documentation are eligible for capitalization under SFAS No. 86. Generally, the Company capitalizes approximately 70% of eligible costs based on an average actual cost per labor hour and expenses the remainder. On an annual basis, the Company evaluates its capitalized software for recoverability against the estimated future revenues over the next five years from the products or services.

In accordance with Emerging Issues Task Force Issue 00-02, "Accounting for Web Site Development Costs", certain marketing costs incurred to develop Web sites are expensed as incurred.

Amortization is based on the greater of the projected to actual revenue ratio or straight-line method and commences in the first full year of product availability and continues over the product's estimated useful life. The estimated useful life for computer software and databases is seven years based on its estimated economic life.

Unamortized computer software was approximately \$2,308,000 in 2006 and \$2,549,000 in 2005. Amortization of computer software was approximately \$707,000 in 2006 and \$670,000 in 2005, respectively, which is included in Cost of Sales on the Statement of Income.

Equipment, Furniture and Leasehold Improvements

Equipment, furniture and leasehold improvements are recorded at historical cost. Equipment, furniture and leasehold improvements at December 31, 2006 and 2005, consist of the following:

	<u>2006</u>	<u>2005</u>
Equipment	\$ 1,550,214	\$ 1,448,041
Furniture and fixtures	<u>392,217</u>	<u>391,764</u>
	1,942,431	1,839,805
Less accumulated depreciation	<u>1,738,869</u>	<u>1,608,139</u>
	<u>\$ 203,562</u>	<u>\$ 231,666</u>

Useful Lives: The following estimated useful lives are generally observed for the respective asset categories:

Equipment	5 years
Furniture and fixtures	5 to 10 years
Leasehold improvements	Shorter of lease term or economic life

Depreciation: Depreciation is based on the straight-line method over the estimated useful life of the asset and commences in the year the asset is placed in and/or is available for service or sale using the half-year convention method. Depreciation expense was \$131,000 in 2006 and \$176,000 in 2005, which is included in Cost of Sales on the Consolidated Statement of Income.

Impairment of Long-lived Assets

The Company periodically assesses the recoverability of the carrying amounts of long-lived assets. An impairment loss is recognized when expected undiscounted future cash flows are less than the carrying amount of the asset. The impairment loss is the difference by which the carrying amount of the asset exceeds its fair value.

Other Assets

In February 2003, A-G Canada, Ltd. a wholly owned Canadian subsidiary of the Company, pledged a Guaranteed Income Certificate in the amount of \$42,500 to Toronto Dominion Bank as collateral for a four-year Letter of Credit. The Guaranteed Income Certificate and associated Letter of Credit both mature and were retired in February 2007.

In May 2005, the Company surrendered its Company-owned keyman life insurance policies and used the proceeds to retire the outstanding loans against the cash surrender value of those policies. Net proceeds were approximately \$101,000 in cash.

Earnings per Share

Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share" requires the presentation of basic earnings per share and diluted earnings per share. Basic and diluted earnings per share computations presented by the Company conform to the standard and are based on the weighted average number of shares of Common Stock outstanding during the year. The Company's Board of Directors granted stock options for a total of 705,000 shares of the Company's restricted Common Stock as of December 31, 2006 to two directors and certain employees of which options for 135,000 shares have been forfeited. For the year ended December 31, 2006 and 2005, there were

common stock equivalents (stock options) outstanding representing 504,483 and 409,900 shares, respectively.

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

	<u>Net Income</u>	<u>Shares</u>	<u>Per Share</u>
<u>Year ended December 31, 2006</u>			
Basic earnings per share			
Net income available to common stockholders	\$ 332,928	5,269,088	\$ 0.06
Effect of dilutive securities			
Stock options	--	504,483	
Diluted earnings per share			
Net income available to common stockholders	<u>\$ 332,928</u>	<u>5,773,571</u>	<u>\$ 0.06</u>
<u>Year ended December 31, 2005</u>			
Basic earnings per share			
Net income available to common stockholders	\$ 311,497	5,525,586	\$ 0.06
Effect of dilutive securities			
Stock options	--	409,900	
Diluted earnings per share			
Net income available to common stockholders	<u>\$ 311,497</u>	<u>5,935,486</u>	<u>\$ 0.05</u>

Comprehensive Income

The Company accounts for comprehensive income in accordance with Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income", which establishes standards for reporting and display of comprehensive income and its components in interim and annual financial statements. Comprehensive income is defined as the change in the equity (net assets) of an entity during a period from transactions, events and circumstances excluding all transactions involving investments by or distributions to the owners.

Supplemental Disclosure of Cash Flow Information

The Company paid no net interest in 2006 compared to \$11,000 in 2005. The Company paid income taxes in the amount of \$49,221 in 2006 and \$5,846 in 2005.

Segment Reporting

As of the year ended December 31, 1998, the Company adopted Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information". The Statement establishes standards for reporting information about operating segments in interim and annual financial statements.

The following table summarizes sales based on the location of the customers and assets based on the location of the asset presented on the basis of generally accepted accounting principles for the years ended December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Geographic areas		
Net sales		
United States	\$ 4,455,433	\$ 4,226,691
Foreign – Canada/Other	875,163	923,700
Long-lived assets, net		
United States	2,511,268	2,780,961
Foreign - Canada	--	--

There is one customer account which represents more than 10% (13% and 14%) of the Company's net sales as of December 31, 2006 and 2005, respectively. There are two customer accounts which represent more than 10% of the Company's accounts receivable as of December 31, 2006 and both accounts were collected in 2007.

Recently Issued Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. This Statement applies to all entities and permits entities to choose to measure many financial instruments and certain other eligible items at fair value at specified election dates and report unrealized gains and losses for which the fair value option has been elected in earnings. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements (see below). The adoption of SFAS No. 159 is not expected to affect the Company's financial condition or results of operations.

In September 2005, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the provisions of the statement, but does not anticipate that the adoption of SFAS No. 157 will have a material impact on the Company's consolidated financial statements.

In June 2005, the FASB issued Financial Interpretation ("FIN") No. 48, Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109 – Accounting for Income Taxes. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. The provisions of this Interpretation will become effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 in 2007 is not expected to have a significant impact upon the Company's financial condition or results of operations.

2. Credit Facilities

In August 2006, the bank renewed and extended the Company's credit facility through May 1, 2008. The credit facility is composed of a \$500,000 revolving line of credit for working capital and a second \$1,000,000 five-year term facility to fund major investments. The interest rate on both credit facilities is the bank prime rate plus 1.0% margin (9.25% at December 31, 2006). The credit facility is secured by all of the assets of the Company and its subsidiary, A-G Canada Ltd. and requires that the Company maintain certain minimum financial covenant ratios. The Company was in compliance with all of its financial loan covenants, there were no outstanding borrowings under either credit facility and there was \$1,500,000 in available credit as of December 31, 2006.

3. Income Taxes

The provision for taxes based on income is composed of the following for the years ended December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
<u>Current taxes based on income</u>		
Federal	\$ 4,000	\$ 12,000
State	35,000	(11,000)
Foreign	--	--
	<u>39,000</u>	<u>1,000</u>
<u>Deferred taxes based on income</u>		
Federal	--	--
State	--	(1,000)
Foreign	--	--
	<u>--</u>	<u>(1,000)</u>
Total Tax Provision	<u><u>\$ 39,000</u></u>	<u><u>\$ --</u></u>

A reconciliation of the provision for taxes based on income follows for the years ended December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Statutory Rate	34%	34%
Statutory U.S. Federal income tax	\$ 126,000	\$ 106,000
Adjustments for foreign tax rates	(2,000)	(10,000)
State tax, net of Federal benefit	23,000	(8,000)
Change in valuation allowance	(116,000)	(242,000)
Other	8,000	155,000
	<u>8,000</u>	<u>155,000</u>
Total Tax Provision	<u><u>\$ 39,000</u></u>	<u><u>\$ --</u></u>

The deferred tax assets and liabilities are composed of the following at December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
<u>Current deferred taxes</u>		
Bad debts/accrued vacation/other	\$ 58,000	\$ 83,000
<u>Non-current deferred taxes</u>		
Deferred tax assets:		
Net operating loss	990,000	1,148,000
AMT Credits/other	7,000	16,000
	<u>997,000</u>	<u>1,164,000</u>
Deferred tax liabilities:		
Tax over book amortization and depreciation	<u>(509,000)</u>	<u>(509,000)</u>
Net deferred tax assets	488,000	655,000
Valuation allowance	<u>(554,000)</u>	<u>(746,000)</u>
Net non-current deferred tax liability	<u>(66,000)</u>	<u>(91,000)</u>
Net deferred tax liability	<u>\$ (8,000)</u>	<u>\$ (8,000)</u>

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been reported in the Company's financial statements or tax returns. The valuation allowance at December 31, 2006 and 2005 reflects an unrecognized U.S. and foreign tax loss carryforward. At December 31, 2006, the Company had available net operating loss carryforwards of \$2,552,000 for federal income tax purposes, \$1,139,000 for state income tax purposes and \$49,000 for foreign income tax purposes. These net operating loss carryforwards expire from 2020 to 2024 for federal taxes, 2012 to 2013 for state taxes, and 2010 to 2013 for foreign taxes.

4. Commitments and Contingencies.

The Company incurred total facilities and equipment lease and rental expense of approximately \$254,000 in 2006 and \$267,000 in 2005. The Company is obligated under certain non-cancelable operating leases for office facilities and equipment expiring in 2009 and 2012. (See Note 5 below).

Approximate future minimum lease commitments as of December 31, 2006 are as follows:

<u>Years ended December 31,</u>	<u>Operating Leases</u>
2007	\$ 266,000
2008	276,000
2009	283,000
2010	275,000
2011	283,000
2012	<u>292,000</u>
Total minimum lease payments	<u>\$ 1,675,000</u>

From time to time, the Company is involved in legal proceedings incidental to its normal business activities. Management does not believe that the outcome of these proceedings will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

5. Related Party Transactions.

The Company previously leased its corporate office facility from a limited partnership owned by a current and a former director/stockholder of the Company. On February 16, 2007, the building housing the corporate office facility was sold by the limited partnership to an unrelated and independent third party. In December 2006, a new five-year lease expiring December 31, 2012 was approved by the independent member of the Company's Board of Directors. The new lease will reduce the square footage occupied to 10,300 square feet. The base rent was \$239,000 and \$233,000 plus expenses in 2006 and 2005, respectively. Management believes that the reconfigured space will be sufficient for the Company's current and foreseeable future needs. The Company also renewed a three year lease through December 31, 2009 on a small sales and support office in Toronto, Canada for its wholly owned subsidiary, A-G Canada, Ltd.

Robert S. Cope, a shareholder, retired as President after 45 years of service to the Company in July 2004. Mr. Cope retains the position of Chairman of the Board and received \$60,500 and \$30,500 in director fees and expenses in 2006 and 2005, respectively.

James R. Yarter, a shareholder, has been a director of the Company since June 2001 and was paid \$25,150 and \$27,040 in director fees and expenses in 2006 and 2005, respectively. Mr. Yarter retired in December, 2006. The Company agreed to purchase

Mr. Yarter's stock and exercised stock options for a net cost of \$609,000 (See "Stock Purchases" in Note 6 below).

Thomas J. Dudley, a shareholder, has been a director of the Company since July 2002 and was paid \$25,112 and \$31,061 in director fees and expenses in 2006 and 2005, respectively.

6. Stockholders' Equity.

Tender Offer

On October 12, 2006, the Company launched a tender offer to repurchase up to 1,000,000 shares of common stock from the public at a price not less than \$0.50 per share or greater than \$0.85 per share payable in cash. Funding for the tender offer was provided by available cash. The tender offer expired on November 15, 2006. The Company purchased approximately 405,000 shares of its common stock at a total cost of approximately \$356,000 including fees and expenses. These shares were retired and returned to authorized but unissued Common Stock.

Stock Purchases

In February 2006, the Company purchased 185,000 shares of its outstanding common stock in a private transaction for a total cost of approximately \$83,250. The share repurchase transaction was approved by the Board of Directors, major shareholders and reviewed by the Company's primary bank. These shares were retired and returned to authorized but unissued common stock.

On December 21, 2006, James R. Yarter, a director and member of the Audit Committee since June, 2001 retired from the Board of Directors. In association with Mr. Yarter's retirement, the Board of Directors has agreed to purchase Mr. Yarter's 637,710 shares of common stock at \$0.85 per share for a total cost of approximately \$542,000 in the first quarter of 2007. These shares were purchased in February 2007 and were retired and returned to authorized but unissued common stock. The Board has also agreed to fully vest and purchase Mr. Yarter's 140,000 stock options at \$0.85 per share for a net cost of approximately \$44,000 (net of tax) in the second quarter of 2007. The Company has accrued a liability in the amount of \$609,000 at December 31, 2006 for the purchase to be completed in 2007. Following this transaction, the Company will have purchased a total of approximately 1,228,000 shares (22% of its outstanding shares) at a total cost of approximately \$1,049,000 in 2006. These transactions reduce the Company's shares outstanding to 4,297,610 and diluted shares outstanding to 4,727,510.

2002 Qualified and Non-qualified Stock Option Plan

The Company adopted a qualified and non-qualified stock option plan following approval by its shareholders at its 2001 annual shareholder's meeting held on February 27, 2002. The 2002 Stock Option Plan was amended on October 21, 2004 to increase the number of available options to purchase shares to 800,000. As of December 31, 2006, the Board of Directors has granted options for a total of 705,000 shares of which 135,000 have since been forfeited, 100 shares exercised and 140,000 shares expected to be issued and later repurchased for a net total of 429,900 shares granted and unexercised at an average market price of \$0.42. Of these granted shares, 342,400 shares have vested and are eligible for exercise at an average exercise price of \$0.33. Under the plan, the stock option price per share for options granted is determined by the Board of Directors and is based on the market price of the Company's common stock on the date of grant. The stock options vest over four years and no option can be exercised later than ten years from the date it was granted.

In 2005, stock options were accounted for under Accounting Principles Board Opinion No. 25 using the intrinsic value method. Accordingly, no stock option expense was recorded in years prior to and including 2005, since the exercise price of the options issued has always been equal to the fair market value on the date of grant. In December 2005, the Financial Accounting Standards Board ("FASB") reissued SFAS No. 123R, "Share-Based Payment." This Statement is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement requires that the cost resulting from all share-based payment transactions be recognized in the financial statements effective as of the beginning of the first interim or annual reporting period beginning after December 15, 2005. The Company has adopted this Standard in 2006 and applied the Standard using the modified prospective method from January 1, 2006. The valuation provisions of SFAS 123R apply to new awards and to awards that are outstanding on the effective date and subsequently modified or cancelled. Under the modified prospective method, prior periods are not revised for comparative purposes. The Company determined compensation cost based on the fair value for its fully vested stock options at grant date, under SFAS 123R, the Company's total compensation expense inception-to-date (net of tax) is approximately \$11,000 and the total compensation expense (net of tax) would be approximately \$34,000 based on current stock options grants.

Net income and basic and diluted earnings per share would have been reduced to the following as reported and pro forma amounts indicated below for 2005:

	<u>2005</u>
Net income as reported	\$ 311,497
Less stock-based compensation expense (net of tax)	<u>(6,188)</u>
Pro forma net income (net of tax)	\$ 305,309
Earnings per share:	
As reported:	
Basic	\$ 0.06
Diluted	\$ 0.05
Pro forma:	
Basic	\$ 0.06
Diluted	\$ 0.05

The fair value for these options was estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Expected life	Five Years	Five Years
Risk-free interest rate	5.0%	3.8%
Expected volatility	30%	30%
Dividend yield	0%	0%
Fair value of options granted at fair market price	\$0.20	\$0.14

All options granted were at the fair market price.

Transactions involving stock options are summarized as follows:

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Balance at December 31, 2004	479,900	\$ 0.36
Granted during 2005	30,000	0.45
Forfeited during 2005	<u>(100,000)</u>	0.40

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Balance at December 31, 2005	409,900	0.35
Granted during 2006	165,000	0.55
Stock options to be exercised and later to be repurchased (See Note 6)	(140,000)	0.37
Forfeited during 2006	<u>(5,000)</u>	0.40
Balance at December 31, 2006	<u>429,900</u>	\$ 0.42

Additional information with respect to the outstanding options as of December 31, 2006 excluding optioned shares to be purchased in 2007 (See Note 6) is as follows:

Option Exercise Price Range	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number of Shares</u>	<u>Average Remaining Contractual Life(Yrs.)</u>	<u>Weighted Average Exercise Price</u>	<u>Number of Shares</u>	<u>Average Exercise Price</u>
\$0.30 to 0.399	174,900	5.73	\$ 0.30	174,900	\$ 0.30
\$0.40 to 0.499	100,000	7.04	0.41	67,500	0.40
\$0.50 to 0.599	<u>155,000</u>	9.41	0.55	<u>--</u>	0.55
	<u>429,900</u>	7.36	\$ 0.42	<u>242,400</u>	\$ 0.33

1997 Non-qualified Stock Option Plan

The Company adopted a 1997 Non-qualified Stock Option Plan effective December 31, 1997. The Plan consists of 300,000 shares of the Company's authorized but unissued Common Stock which has been reserved for possible future grants under the Plan. The plan is a non-qualified plan covering only senior executives and related persons. As of December 31, 2006 there were no outstanding grants of options under the Plan and no grants are currently planned.

7. 401(k) Plan.

The Company sponsors a defined contribution plan qualified under Section 401(k) of the Internal Revenue Code for the benefit of its U.S. based employees. All full time employees are eligible to participate. The Company pays the administrative expenses of the plan. Annually, the Company may, at its sole discretion, award an amount as a match against employee contributions to the 401(k) plan. The Company contribution was approximately \$18,000 in 2006 and \$17,000 in 2005.