

QUARTERLY REPORT

For the period ended September 30, 2006

of

ELEGANT ILLUSIONS, INC.

**542 Lighthouse Ave.
Suite 5
Pacific Grove, CA 93950
(831) 649-1814**

www.elegant-illusion.com

In October 2002, Elegant Illusions, Inc. filed a Form 15 with the Securities and Exchange Commission terminating registration of its Common Stock under the Securities Exchange Act of 1934. As a result, it is no longer obligated to file periodic reports with the Securities and Exchange Commission. **This report is not a quarterly report on Form 10-QSB.**

FINANCIAL INFORMATION

Financial Statements

The accompanying financial statements are unaudited for the interim periods, but include all adjustments (consisting only of normal recurring accruals) which our management considers necessary for the fair presentation of results for the three and nine months ended September 30, 2006.

Moreover, these financial statements do not purport to contain complete disclosure in conformity with generally accepted accounting principles and should be read in conjunction with our audited financial statements at, and for the fiscal year ended December 31, 2005. If you would like a copy of such audited financial statements, please contact us and we will send them to you free of charge.

The results reflected for the three and nine months ended September 30, 2006 are not necessarily indicative of the results for the entire fiscal year.

**ELEGANT ILLUSIONS, INC AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)**

	December 31, <u>2005</u>	September 30, <u>2006</u>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$1,191,366	\$908,821
Accounts receivable	122,706	80,745
Income taxes receivable	94,938	253,902
Inventory	4,737,844	5,058,729
Prepaid expenses	<u>235,074</u>	<u>271,948</u>
TOTAL CURRENT ASSETS	6,381,927	<u>6,574,145</u>
PROPERTY AND EQUIPMENT, NET	<u>1,369,029</u>	<u>1,291,647</u>
OTHER ASSETS	<u>73,409</u>	<u>73,959</u>
	<u>\$7,824,365</u>	<u>\$7,939,752</u>
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Current portion of long term debt	\$23,685	\$24,912
Due to Bank		500,000
Accounts payable and accrued expenses	<u>132,980</u>	<u>152,865</u>
TOTAL CURRENT LIABILITIES	<u>156,665</u>	<u>677,777</u>
LONG TERM DEBT		
Mortgage payable	305,654	270,533
Deferred income taxes	<u>55,000</u>	<u>55,000</u>
	<u>360,654</u>	<u>325,533</u>
TOTAL LIABILITES	<u>517,319</u>	<u>1,003,310</u>
STOCKHOLDERS' EQUITY		
Common stock-authorized 10,000,000 shares, \$.001 per value, issued and outstanding 6,146,446 shares in 2005 and 2006	6,147	6,147
Additional paid in capital	3,914,509	3,914,509
Retained earnings	3,470,398	3,099,794
Less treasury stock at cost (62,067 shares in 2005 and 2006)	<u>(84,008)</u>	<u>(84,008)</u>
	<u>7,307,046</u>	<u>6,936,441</u>
	<u>\$7,824,365</u>	<u>\$7,939,752</u>

See Accompanying Notes to Consolidated Financial Statements

ELEGANT ILLUSIONS, INC AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2006
(Unaudited)

	<u>2005</u>	<u>2006</u>
REVENUES	\$5,665,253	\$4,391,592
COST OF GOODS SOLD	<u>1,408,435</u>	<u>1,083,263</u>
GROSS PROFITS	4,256,818	3,308,329
EXPENSES		
SELLING, GENERAL AND ADMINISTRATION	4,127,095	3,728,503
DEPRECIATION, AND AMORTIZATION	208,497	164,592
INTEREST EXPENSE	<u>14,138</u>	<u>16,839</u>
	<u>4,349,730</u>	<u>3,909,934</u>
INCOME (LOSS) BEFORE INCOME TAXES	(92,912)	(601,605)
PROVISION FOR INCOME TAXES	<u>(35,000)</u>	<u>(231,000)</u>
NET INCOME (LOSS)	<u>(\$57,912)</u>	<u>(\$370,605)</u>
WEIGHTED AVERAGE SHARES OUTSTANDING	<u>6,084,379</u>	<u>6,084,379</u>
BASIC AND DILUTED INCOME PER SHARE	<u>(\$0.01)</u>	<u>(\$0.06)</u>

See Accompanying Notes to Consolidated Financial Statements

ELEGANT ILLUSIONS, INC AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2006
(Unaudited)

	<u>2005</u>		<u>2006</u>
REVENUES	\$1,723,614		\$1,508,798
COST OF GOODS SOLD	<u>463,817</u>		<u>340,775</u>
GROSS PROFITS	1,259,797		1,168,023
EXPENSES			
SELLING, GENERAL AND ADMINISTRATION	1,272,537		1,271,872
DEPRECIATION, AND AMORTIZATION	85,455		48,744
INTEREST EXPENSE	<u>4,938</u>		<u>5,785</u>
	<u>1,362,930</u>		<u>1,326,402</u>
INCOME (LOSS) BEFORE INCOME TAXES	(103,133)		(158,379)
PROVISION FOR INCOME TAXES	<u>(39,000)</u>		<u>(60,000)</u>
NET INCOME (LOSS)	<u>(\$64,133)</u>		<u>(\$98,379)</u>
WEIGHTED AVERAGE SHARES OUTSTANDING	<u>6,084,379</u>		<u>6,084,379</u>
BASIC AND DILUTED INCOME PER SHARE	<u>(\$0.01)</u>		<u>(\$0.02)</u>

See Accompanying Notes to Consolidated Financial Statements

ELEGANT ILLUSIONS, INC AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2006
(unaudited)

	<u>2005</u>	<u>2006</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	(\$57,912)	(\$370,605)
Adjustments to reconcile net income		
To net cash provided by (used in)		
operating activities		
Depreciation and amortization	208,497	164,592
Abandonment of property and equipment	16,399	12,579
Changes in operating assets and liabilities		
(Increase) Decrease in:		
Accounts receivable	(118,019)	41,960
Inventory	155,743	(320,886)
Prepaid expenses	(44,806)	(36,874)
Income tax receivable	(26,837)	(158,964)
Increase (Decrease in)		
Accounts payable and accrued expenses	(80,466)	19,885
Income taxes payable	<u>0</u>	<u>0</u>
NET CASH PROVIDED BY (USED IN) OPERATIONS	<u>52,599</u>	<u>(648,312)</u>
CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(244,292)	(99,790)
Other assets	<u>(4,563)</u>	<u>(549)</u>
NET CASH USED IN INVESTING ACTIVITIES	<u>(248,855)</u>	<u>(100,339)</u>
CASH FLOW FROM FINANCING ACTIVITIES		
Bank Debt		500,000
Mortgages payable	<u>(33,894)</u>	<u>(33,894)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(33,894)</u>	<u>466,106</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	(230,150)	(282,545)
CASH AND CASH EQUIVALENT BALANCE		
Beginning of period	<u>1,229,305</u>	<u>1,191,366</u>
CASH AND CASH EQUIVALENT BALANCE		
End of Period	<u>\$999,155</u>	<u>\$908,821</u>
SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest Paid	<u>\$4,937</u>	<u>\$16,839</u>
Income taxes paid	<u>0</u>	<u>\$0</u>

See Accompanying Notes to Consolidated Financial Statements

ELEGANT ILLUSIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

1. COMMENTS

The accompanying unaudited consolidated condensed financial statements, which are for interim periods, do not include all disclosure provided in the annual consolidated financial statements. These unaudited consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto contained in the Annual Report for the year ended December 31, 2005 of Elegant Illusions, Inc (the "Company").

The December 31, 2005 consolidated condensed balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (which are of a normal recurring nature) necessary for a fair presentation of the financial statements. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full fiscal year.

2. EFFECTS OF HURRICANE KATRINA

Our operations and financial condition were significantly and adversely affected by Hurricane Katrina. All three New Orleans locations were closed effective August 29, 2005. The two Bourbon Street locations re-opened December 2, 2005; however the Riverwalk location remains closed and management is currently negotiating with the Riverwalk Marketplace Mall on conditions and a time, satisfactory to both parties, to re-open this location. Management does not know when or if this will occur.

Management has determined that, as of September 30 2006, the Bourbon Street and Riverwalk jewelry stores sustained business income losses of approximately \$168,646 and \$136,736, respectively. The Bourbon Street Gallery sustained business income losses of approximately \$14,191.

Additionally Management has determined the Riverwalk location sustained inventory, equipment and extra expense losses of approximately \$199,379. Of these losses totaling approximately \$518,952, as of September 30, 2006, the Company's Insurance Carrier has reimbursed the Company an aggregate amount of \$518,952.

Management has also estimated certain costs for restoring the Riverwalk location of approximately \$23,935. Management cannot be certain if actual restoration costs will exceed this amount.

Management's Discussion And Analysis Of Financial Condition And Results Of Operations

Cautionary Statement on Forward-Looking Statements

Except for the historical information contained herein, certain of the matters discussed in this report are "forward-looking statements," which involve certain risks and uncertainties, which could cause actual results to differ materially from those discussed herein. Forward-looking information generally is information stated to be anticipated, expected or projected by us. The following list, which is not intended to be an all encompassing list of risks and uncertainties affecting us and our business, summarizes several factors that could cause our actual results to differ from those anticipated or expected in these forward-looking statements: that low or negative growth in the economy or in the financial markets will reduce discretionary spending on goods such as those sold in our stores; that warehousing and distribution productivity and capacity can be further improved to support our distribution requirements; that changes in expenses (such as changes in our labor, rent and/or inventory purchase costs) could adversely affect our results of operations; that competition may impact our sales efforts by diminishing sales and/or requiring us to cut prices; that seasonality of the retail created gem jewelry business or downturns in consumer spending during the fourth quarter may adversely affect our operating results; that we may not be able to continue to manage our inventory and product supply effectively to respond to consumer demand; that fluctuations in created gem prices may negatively affect the business; that sustained adverse weather conditions may adversely affect our sales; that legal or governmental proceedings may have an adverse effect on our financial results or reputation; that alternate sources of merchandise supply may not be available on favorable terms to us; that key personnel who have been hired or retained by us may depart; or that changes in government or regulatory requirements may increase the cost of or adversely affect our operations.

We caution readers that any such forward-looking statements are based on our current expectations and beliefs but are not guarantees of future performance. Actual results could differ materially from those expressed or implied in the forward-looking statements.

Results of Operations

Three and Nine Months Ended September 30, 2006 Compared to Three and Nine Months Ended September 30, 2005

Sales for the three months ended September 30, 2006 decreased \$214,816 or approximately 12.5% when compared to the three months ended September 30, 2005. Sales for the nine months ended September 30, 2006 decreased \$1,272,661 or approximately 22.5% when compared to the nine months ended September 30, 2005.

Management believes that these significant decreases in Company wide sales were a direct result of Hurricane Katrina, its continued effect in the aftermath (see "Effects of Hurricane Katrina" below) and a reduction in sales at locations open more than a year (see "Revenues Same Store Locations" below). Historically, our New Orleans locations generate a

significant amount of our revenues. As of September 30, 2005, we operated 22 retail locations and, as of September 30, 2006, we operated 18 retail locations excluding the Riverwalk location.

Costs of goods as a percentage of revenues decreased from approximately 26.9% during third quarter of 2005 to approximately 22.6% during the third quarter of 2006.

Cost of goods as a percentage of revenues for the nine months ending September 30, 2005 decreased slightly from approximately 24.9% during 2005 to approximately 24.7% during 2006.

Management believes that these decreases primarily resulted from increasing retail prices to reflect current gold and silver costs and our purchasing inventory at lower gold and silver prices, before the rapid and steep increases in the past year.

During the three months ended September 30, 2006, selling, general and administrative expenses decreased when compared to the three months ended September, 2005 by \$665. However, as a percentage of sales, selling, general and administrative expenses increased from approximately 73.8% during the three months ended September 30, 2005 to approximately 84.3% during the three months ended September 30, 2006.

During the nine months ended September 30, 2006, selling, general and administrative expenses decreased when compared to the nine months ended September 30, 2005 by \$398,592 (approximately 9.7%). However, as a percentage of sales, selling, general and administrative expenses increased from approximately 72.8% during the nine months ended September 30, 2005 to approximately 84.9% during the nine months ended September 30, 2006.

Management believes the increase in selling, general and administrative expenses as a percentage of sales is the result of revenues decreasing more than expenses during each of the three quarters in 2006 and an approximate amount of \$13,000, costs associated with abandonment of assets at closed locations.

Revenues Same Store Locations.

As of September 30, 2006, we operated 16 locations that were also in operation and open for the full quarter at September 30, 2005: one in Balboa, one in Philadelphia, three in Monterey, one in Sacramento, one in San Diego, one in San Francisco, one in Palm Springs, one in Branson, one in Laughlin, one in Miromar, one in Sarasota, one in Wailea, Hawaii, one in Maui, Hawaii and one in Vail.

As of September 30, 2006, we operated 14 locations that were also in operation and open for the full nine months at September 30, 2005: three in Monterey, one in Sacramento, one in San Diego, one in San Francisco, one in Palm Springs, one in Branson, one in Laughlin, one in Miromar, one in Sarasota, one in Wailea, Hawaii, one in Maui, Hawaii and one in Vail.

Revenues from these locations for the quarter ended September 30, 2006, decreased approximately 4.4% from the same period in 2005. Revenues from these locations for the nine months ending September 30, 2006 decreased approximately 11.6% from the same period in 2005.

Management believes this decrease in same store revenues is the result of a middle class experiencing shrinking discretionary funds resulting from fewer higher paying jobs in the market place, higher energy and housing costs. We are realizing fewer sales as a result of higher gold prices.

Effects Of Hurricane Katrina

Our operations and financial condition were significantly and adversely affected by Hurricane Katrina. All three New Orleans locations were closed effective August 29, 2005. The two Bourbon Street locations re-opened December 2, 2005; however the Riverwalk location remains closed and management is currently negotiating with the Riverwalk Marketplace Mall on conditions and a time, satisfactory to both parties, to re-open this location. Management does not know when or if this will occur.

Management has determined that, as of September 30, 2006, the Bourbon Street and Riverwalk jewelry stores sustained business income losses of approximately \$168,646 and \$136,736, respectively. The Bourbon Street Gallery sustained business income losses of approximately \$14,191.

Additionally Management has determined the Riverwalk location sustained inventory, equipment and extra expense losses of approximately \$199,379. Of these losses totaling approximately \$518,952, as of September 30, 2006, our Insurance Carrier has reimbursed us an aggregate amount of \$518,952.

Management has also estimated certain costs for restoring the Riverwalk location of approximately \$23,935. Management cannot be certain if actual restoration costs will exceed this amount.

Net Income (Loss)

During the three months ended September 30, 2006, we realized a net loss of \$98,379 compared to net loss of \$64,133 for the three months ended September 30, 2005. During the nine months ended September 30, 2006, we realized a net loss of \$370,605 compared to a net loss of \$57,912 for the nine months ended September 30, 2005. Management is working diligently to reduce the downward trend in same store and company revenues and reduce operating costs. However management expects losses to continue through the third quarter of 2007.

Inventory Turnover Ratios

During the three months ended September 30, 2006, we maintained an inventory that provided a turnover ratio of 0.3 to 1. We believe that this inventory turnover ratio is appropriate for our plan of operation, including maintaining our strategy of replacing inventory sold at our retail locations within a 2-3 day time frame. We review items on hand, on a regular basis, to determine slow moving items, then discount the price of those items so they are sold at prices that still generate a positive gross margin. The inventory turnover ratio for the three months ended September 30, 2005 was 0.6 to 1.

Liquidity and Capital Resources

As of September 30, 2006, we had \$908,821 in cash and cash equivalents, down \$282,545 from December 31, 2005, and our current assets exceeded our current liabilities by \$5,896,368, down \$328,894 from December 31, 2005.

Although we opened two new stores in 2005, Balboa Island in Newport Beach, California and Franklin Mills in Philadelphia, and continue to look for potential new store locations, store expansion is not our primary focus. Our Primary focus is on operating controls and costs.

We closed our Birch Run location in May 2006 and closed our two St. Croix locations in August, 2006 because we are unable to obtain appropriate insurance coverage and favorable rent conditions for these locations. We plan on closing our Philadelphia and Miromar locations because revenues are not meeting expectations.

Our primary anticipated capital expenditure during the last quarter of 2006 and the first half of 2007 will be the possible opening of one created gem jewelry store.

We also have engaged our first Independent Sales Representative. We anticipate that the Independent Sales Representative will introduce a line of Elegant Illusions Jewelry to retail jewelry stores in the Central and Northern parts of California and Nevada.

We have designed and manufactured a new line of jewelry under our registered trademark "Platinique". We introduced this line of jewelry in our created gem jewelry store locations during the month of October 2006.

We believe that we have sufficient capital reserves for all of the foregoing activities.

Off-Balance Sheet Transactions

We do not have any transactions, agreements or other contractual arrangements that constitute off-balance sheet arrangements.

Application Of Critical Accounting Policies

Financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us relate to impairment of long-lived assets, and the costing of inventory as it relates to obsolescence and marketability.

Actual results could differ from those estimates. For example, unexpected changes in market conditions or a downturn in the economy could adversely affect actual results. Estimates are used in accounting for, among other things, inventory obsolescence, depreciation, taxes, and

contingencies. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the Consolidated Financial Statements in the period they are determined to be necessary.

Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its Consolidated Financial Statements.

Merchandise Inventories. Merchandise Inventories are stated at the lower of cost or market. Management is constantly reviewing the turnover of individual items to determine if adjustments in pricing are required to affect the sales of said products. Substantially all inventories represent finished goods which are valued using the first-in, first-out (FIFO) inventory method.

We also write down our inventory for discontinued, slow-moving and damaged inventory if required. This write-down is equal to the difference between the cost of inventory and its estimated market value based upon assumptions of targeted inventory turn rates, future demand, management strategy, and market conditions. If actual market conditions are less favorable than those projected by management, or management strategy changes, additional inventory write-downs may be required and, in the case of a major change in strategy or downturn in market conditions, such write-downs could be significant.

Shrinkage is estimated for the period from the last inventory date to the end of the fiscal year on a store by store basis. Such estimates are based on experience and the shrinkage results from the last physical inventory. Physical inventories are taken annually for all store locations and for the distribution warehouse. The shrinkage rate from the most recent physical inventory, in combination with historical experience, is the basis for providing a shrinkage reserve if required.

Long-lived Assets. Long-lived assets are periodically reviewed for impairment by comparing the carrying value of the assets with their estimated fair values. If the evaluation indicates that the carrying amount of the asset may not be recoverable, the potential impairment is measured based on a projected discounted cash flow method, using a discount rate that is considered to be commensurate with the risk inherent in our current business model. Assumptions are made with respect to cash flows expected to be generated by the related assets based upon updated projections. Any changes in key assumptions or market conditions could result in an unanticipated impairment charge. For instance, in the event of a major market downturn, individual stores may become unprofitable, which could result in a write-down of the carrying value of the assets located in those stores. Any impairment would be recognized in operating results if a permanent reduction were to occur.

Revenue Recognition. We recognize revenue related to merchandise sales at the time of the sale, reduced by a provision for returns. The provision for sales returns is based on historical evidence of our return rate.

Income Taxes Income taxes are estimated for each jurisdiction in which we operate. This involves assessing the current tax exposure together with temporary differences resulting from

differing treatment of items for tax and accounting purposes. Any resulting deferred tax assets are evaluated for recoverability based on estimated future taxable income.

Issues And Uncertainties

The risks and uncertainties discussed in “*Cautionary Statement on Forward-Looking Statements*” above, among others, should be considered in evaluating our financial outlook.

Other Information

We have a pending legal dispute with the landlord of our San Francisco location. The landlord is seeking to relocate our store within the mall as is his right under the lease. However, he is required to relocate us to comparable space and we believe that the location chosen is not comparable. The matter is scheduled for a hearing.