

TALON INTERNATIONAL, INC.

Form 10-K

March 26, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2011

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

Commission file number 1-13669

TALON INTERNATIONAL, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

21900 Burbank Blvd., Suite 270  
Woodland Hills, California  
(Address of Principal Executive Offices)

91367  
(Zip Code)

(818) 444-4100

(Registrant's Telephone Number, Including Area Code)

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

None

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

Common Stock, \$.001 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registration is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company  [X]

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

At June 30, 2011, the aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant was \$2,286,331.

At March 23, 2012 the issuer had 21,900,808 shares of Common Stock, \$.001 par value, issued and outstanding.

#### DOCUMENTS INCORPORATED BY REFERENCE

None.

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## TALON INTERNATIONAL, INC.

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## Forward Looking Statements

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

## PART I

### ITEM 1. BUSINESS

#### General

Talon International, Inc. specializes in the manufacturing and distribution of a full range of apparel accessories including zippers and trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We manufacture and distribute zippers under our Talon® brand name to manufacturers for apparel brands and retailers such as Abercrombie & Fitch, JC Penney, Wal-Mart, Kohl's, Juicy Couture and Phillips-Van Heusen, among others. We also provide full service outsourced trim design, sourcing and management services and supply specified trim items for manufacturers of fashion apparel such as Victoria's Secret, Tom Tailor, Abercrombie & Fitch, American Eagle, Polo Ralph Lauren, New York and Company, Express, and others. Under our Tekfit® brand, we develop and sell a stretch waistband that utilizes a patented technology.

We were incorporated in the State of Delaware in 1997. We were formed to serve as the parent holding company of Tag-It, Inc., a California corporation, Tag-It Pacific (HK) LTD, a BVI corporation, Tagit de Mexico, S.A. de C.V., A.G.S. Stationery, Inc., a California corporation, and Pacific Trim & Belt, Inc., a California corporation. All of these companies were consolidated under a parent limited liability company in October 1997 and became our wholly owned subsidiaries immediately prior to the effective date of our initial public offering in January 1998. In 2000, we formed two wholly owned subsidiaries of Tag-It Pacific, Inc.: Tag-It Pacific Limited, a Hong Kong corporation and Talon International, Inc., a Delaware corporation. During 2006 we formed two wholly owned subsidiaries of Talon International, Inc. (formerly Tag-It Pacific, Inc.): Talon Zipper (Shenzhen) Company Ltd. in China and Talon International Pvt. Ltd., in India. On July 20, 2007 we changed our corporate name from Tag-It Pacific, Inc. to Talon

International, Inc. Our website is [www.talonzippers.com](http://www.talonzippers.com).

Our website address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on our website is not and should not be considered part of this report and is not incorporated by reference in this document.

## Business Summary

We operate our business within three product groups, Talon, Trim and Tekfit. In our Talon group, we design, engineer, test and distribute zippers under our Talon trademark and trade names to apparel brands and manufacturers. Talon enjoys brand recognition in the apparel industry worldwide. Talon is a 100-year-old brand, which is known for its quality and product innovation and was the original pioneer of the formed wire metal zipper for the jeans industry, and is a specified zipper brand for manufacturers in the designer, sportswear and outerwear markets worldwide. We provide a line of high quality zippers, including a specialty zipper for kids clothing, for distribution to apparel manufacturers worldwide, including principally Hong Kong, China, Taiwan, India, Indonesia, Bangladesh, the EU, Mexico and Central America. We have sales and marketing teams in most of these areas. We have developed joint manufacturing arrangements in various geographical international local markets to manufacture, finish and distribute zippers under the Talon brand name. Our manufacturing partners operate to our specifications and under our quality requirements, raw material controls and our direct manufacturing and quality assurance supervision, producing finished zippers for our customers in their local markets. Our operating structure allows us to significantly improve the speed at which we serve the market and to effectively expand the geographic footprint of our Talon products.

In our Trim products group, we act as a fully integrated single-source supplier, designer and sourcing agent for a full range of trim items for manufacturers of fashion apparel. Our business focuses on servicing all of the trim requirements of our customers at the manufacturing and retail brand level of the fashion apparel industry. Trim items include labels, buttons, rivets, printed marketing material, polybasic, packing cartons and hangers. Trim items comprise a relatively small part of the cost of most apparel products but comprise the vast majority of components necessary to fabricate and finish a typical apparel product. We offer customers a one-stop outsource service for all zipper and trim related matters. Our teams work with industry merchants and designers and function as an extension of their staff.

Our Talon and Trim products teams collaborate with customers on their design vision and present examples of their vision in graphic form for all apparel accessory components. We design the buttons, snaps, hang tags, labels, zippers, zipper pullers and other items to meet the customers' needs. Once our customer selects the designs they prefer, our sourcing and production teams coordinate with our manufacturing partners worldwide to ensure the best manufacturing solution for the items being produced. The proper manufacturing solution is a critical part of the expertise and service we provide to customers. Selecting the best facility to ensure timely production, the proper finishes, or other material needs or manufacturing techniques to be used is critical. We offer customers a depth and breadth of knowledge in the manufacturing of these products that our customers cannot otherwise achieve. We are consistently innovating new items, manufacturing techniques and finishes; introducing many new, fresh and unique ideas to our customers. Once our customers make a final decision on the accessories that will be used on their garments, we are typically identified as the sole or preferred source supplier for the project, and our customer's factories are then directed to purchase the products directly from us. Throughout the garment manufacturing process, we consistently monitor the timing and accuracy of the production items until finally delivered to our customer's apparel factories.

Under our Tekfit brand we supply apparel manufacturers advanced, patented fabric technologies to produce a unique stretchable waistband for their garments. This technology allows the fabric to be altered through the addition of stretch characteristics resulting in greatly improved fit and comfort. Pant manufacturers use this technology to build-in a stretch factor into standard waistbands that does not alter the appearance of the garment, but will allow the waist to stretch out and back by as much as two waist sizes.



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

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

#### Products

Talon Zippers - We offer a full line of metal, coil and plastic zippers bearing the Talon brand name or logo. Talon zippers are used primarily by manufacturers in the apparel industry and are distributed through our distribution facilities in the United States, Europe, Hong Kong, China, Taiwan, India, Indonesia and Bangladesh and through these designated offices to other international markets.

We expand our distribution of Talon zippers through the establishment of a combination of Talon owned sales, distribution and manufacturing locations, and strategic distribution relationships. These distribution and manufacturing relationships, in combination with Talon owned and affiliated facilities under the Talon brand, improve our time-to-market by allowing us to source, finish and distribute to apparel manufacturers within their local markets. The branded apparel zipper market is dominated by one company and we have positioned Talon to be a viable global alternative to this competitor and capture an increased market share position. We leverage the brand awareness of the Talon name by branding other products in our line with the Talon name.

Trim - We consider our high level of customer service as a fully integrated single-source supplier essential to our success. We combine our high level of customer service within our Trim solutions with a history of design and manufacturing expertise to offer our customers a complete trim solution product. We believe this full-service product gives us a competitive edge over companies that only offer selected trim components because our full service solutions save our customers substantial time in ordering, designing, sampling and managing trim orders from several different suppliers. Our tracking and order management systems allow us to seamlessly supply trim solutions and products to apparel brands, retailers and manufacturers around the world. We produce customized woven, leather, synthetic, embroidered and novelty labels and tapes, which can be printed on or woven into a wide range of fabrics and other materials using various types of high-speed equipment.

Tekfit - We market and supply a proprietary stretch waistband using our patented technology. We provide apparel manufacturers with proprietary equipment, custom materials and an advanced, patented fabric technology that allow for the manufacture of stretch characteristics into their standard waistbands resulting in greatly improved fit and comfort. This technology is used to build-in a stretch factor into standard waistbands that does not alter the appearance of the garment, but will allow the waist to stretch out and back by as much as two waist sizes. Our supply of this product to customers has been limited since 2006 by a licensing dispute. As described more fully in Item 3 “Legal Proceedings”, in March 2012 we ended the licensing dispute, and acquired all U.S. existing licenses and patents for this product technology, and ended all matters of litigation with Pro Fit. This settlement provides us the opportunity to actively expand our marketing and selling of this unique product and brand. The revenues we derived from the sales of products incorporating the stretch waistband technology were substantially limited for the years 2011, 2010 and 2009 as a consequence of this former litigation.

The percentages of total revenue contributed by each of our three primary product groups for the last three fiscal years are as follows:

|                          | Year Ended December 31, |   |      |   |      |   |
|--------------------------|-------------------------|---|------|---|------|---|
|                          | 2011                    |   | 2010 |   | 2009 |   |
| Product Group Net Sales: |                         |   |      |   |      |   |
| Talon zipper             | 54.3                    | % | 59.1 | % | 55.1 | % |
| Trim                     | 45.7                    | % | 40.8 | % | 44.7 | % |
| Tekfit                   | 0.0                     | % | 0.1  | % | 0.2  | % |

## Design and Development

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

Many specialty design companies with which we compete have limited engineering, sourcing or manufacturing experience, and consequently they create products or designs that often cannot be implemented due to limitations in the manufacturing process, the high expense of required materials, or a lack of functionality in the resulting product. We design products to function within the limitations imposed by the applicable materials and manufacturing framework, while meeting our customers specialty needs. Using our manufacturing experience, we ensure delivery of quality products and minimize the time-consuming delays that often arise in coordinating the efforts of independent design houses and manufacturing facilities. By supporting our material procurement and product manufacturing services with design services, we reduce development and production costs and deliver products to our customers sooner than many of our competitors. Our development costs are low, most of which are borne by our customers. Our design teams are based in our U.S. and Asian facilities.

## Customers

We have more than 880 active customers. Our customers include the designated suppliers of well-known apparel retailers and brands, such as VF Corporation, Victoria’s Secret, Tom Tailor, Fat Face, Abercrombie and Fitch, American Eagle, Polo Ralph Lauren, Phillips-Van Heusen, Super Dry, Juicy Couture, Eddie Bauer, Babies-R-Us, and Guess among others. Our customers also include contractors for specialty retailers such as Express and mass

merchant retailers such as Wal-Mart, Kohl's, J.C. Penney, K mart, Sears, and Costco.

For the years ended December 31, 2011, 2010 and 2009, our three largest customers represented approximately 8%, 9% and 9%, respectively, of consolidated net sales.

## Sales and Marketing

We sell our products through our own sales force based in the United States, Hong Kong, China, India, Indonesia, Taiwan, and Bangladesh. We contract with outside sales representatives in the U.S. and Europe, and we develop Central America opportunities through our U.S. sales force and outside sales representatives. We also employ customer service representatives who are assigned to key customers and provide local customer service support. We have developed relationships with our major customers at senior levels and our sales teams actively participate with these customers in their marketing and sales programs and sales strategies. When we become the outsourcing vendor for a customer's packaging or trim requirements, we position ourselves as if we are an in-house department of the customer's zipper and trim procurement operation.

## Sourcing and Assembly

We have developed expertise in identifying high quality materials, competitive prices and approved manufacturers for particular products and materials and ensuring strict adherence to quality manufacturing processes and materials. Our expertise enables us to produce a broad range of apparel accessories and trim products at competitive prices. The majority of products that we procure and distribute are purchased on a finished good basis, manufactured by our partners and under our direct oversight and scrutiny. Raw materials used to manufacture or assemble all of our products are available from numerous sources and are in adequate supply. We purchase products only from qualified material suppliers, and guarantee our customers that all materials used in the manufacture of our products are fully compliant with all government regulations and controls over restricted substances.

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

Principally through our Asian facilities, we distribute Talon zippers, trim items and apparel accessories and oversee the manufacture and distribution of the full range of our products. Our Asian facilities supply customers on numerous significant zipper and trim programs, and serve these customers worldwide.

## Intellectual Property Rights and Licenses

We have trademarks as well as patent rights, copyrights, software copyrights and trade names for which we rely on common law protection, including the Talon trademark. Several of our other trademarks are the subject of applications for federal trademark protection through registration with the United States Patent and Trademark Office, including "Talon", "Tag-It", "Kidzip" and "Tekfit".

## Seasonality

We typically experience seasonal fluctuations in sales volume consistent with the purchase demands of the apparel industry. In most years, these seasonal fluctuations result in lower sales volumes for our business in the first and fourth quarters of each year due to the seasonal buying patterns by the majority of our customers. The apparel retailers typically experience higher sales volumes during the second quarter associated with back-to-school sales and in the fourth quarter in association with year-end holiday purchases. Sales of our products can typically precede the retail sales patterns by 90 to 150 days. Backlogs of sales orders are not considered material in the industries in which we compete, which reduces the predictability and reinforces the volatility of these cyclical buying patterns on our sales volume.



## Inventories

In order to meet the rapid delivery requirements of our customers, we may be required to purchase inventories of raw materials based upon projections made by our customers. In these cases we may carry a substantial amount of inventory on their behalf. We manage this risk by obtaining customer commitments to purchase any excess materials or inventories. These commitments provide that in the event that inventories remain with us in excess of the apparel program life or the termination of production of a customer's product line related to the inventories, the customer is required to purchase the inventories from us under normal invoice and selling terms. While these agreements provide us some advantage in the negotiated disposition of these inventories, we cannot be assured that our customers will complete these agreements or that we can enforce these agreements without adversely affecting our business operations.

## Competition

We operate in highly competitive and fragmented segments of the apparel industry that include numerous local and regional companies that provide some or all of the products we offer. We also compete with United States and international design companies, distributors and manufacturers of tags, trim, packaging products and zippers. Some of our competitors are significantly larger in size and resources than us and have greater name recognition, longer operating histories and more financial and other resources.

Because of our integrated materials, manufacturing and assembly capabilities and our full-service zipper and trim solutions, we believe that we are able to effectively compete for our customers' business, particularly where our customers require a high level of confidence regarding compliance with Restricted Substance regulations, and with the effective coordination of separately sourced production functions. We believe that we successfully compete in our industry by offering superior product pricing, quality, customer service, design capabilities, delivery lead times and complete supply-chain management. We also believe the Talon brand name and the quality of our Talon brand zippers allows us to gain market share in the apparel accessory industry. The unique stretch quality of our Tekfit waistbands will also allow us to compete effectively in the market for waistband components.

## Segment Information

We operate in one industry segment, the distribution of a full range of apparel zipper and trim products to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We separately report our revenues and gross margins by our selling groups in this segment to the extent these are distinguished and separate.

## Financial Information about Geographic Areas

The majority of our products sold are for use by U.S. and European based brands, retailers and manufacturers. The majority of these customers produce their products or outsource the production of their products in manufacturing facilities located outside of the U.S. or Europe, primarily in China, Taiwan, India, Indonesia, Bangladesh and Central America.

A summary of our domestic and international net sales and long-lived assets is set forth in Item 8 of Part II of this Annual Report on Form 10-K, Note 10 in the accompanying Notes to Consolidated Financial Statements.

We are subject to certain risks referred to in Item 1A, "Risk Factors" and Item 3, "Legal Proceedings", including those normally attending international and domestic operations, such as changes in economic or political conditions, currency fluctuations, foreign tax claims or assessments, exchange control regulations and the effect of international relations and domestic affairs of foreign countries on the conduct of business, legal proceedings and the availability

and pricing of raw materials.

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## Employees

As of December 31, 2011, we had approximately 171 full-time employees including 25 in the United States and 146 employees in Asia. Our labor forces are non-union. We believe that we have satisfactory employee and labor relations.

## Corporate Governance and Information Related to SEC Filings

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

## ITEM 1A. RISK FACTORS

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

If we lose our larger customers or they fail to purchase at anticipated levels, our sales and operating results will be adversely affected.

Our results of operations depend to a significant extent upon the commercial success of our larger customers. If these customers fail to purchase our products at anticipated levels, or our relationship with these customers or the retailers they serve diminishes, it may have an adverse effect on our results because: we may lose a primary source of revenue if these customers choose not to purchase our products or services; we may lose the nomination of the retailer or brand; we may not be able to recoup development and inventory costs associated with this customer; and we may not be able to collect our receivables from them.

U.S. and global financial and economic uncertainties could negatively affect our business, results of operations and financial condition.

Our performance is subject to worldwide economic conditions and their impact on levels of consumer spending that affect not only the ultimate consumer, but also retailers, which are served by many of our largest customers. The worldwide apparel industry is heavily influenced by general economic cycles. Purchases of fashion apparel and accessories tend to decline in periods of uncertainty or recession regarding future economic prospects, as disposable income declines. Many factors affect the level of consumer spending in the apparel industries, including, among others: prevailing economic conditions, levels of employment, salaries and wage rates, energy costs, interest rates, the

availability of consumer credit, taxation and consumer confidence in future economic conditions. During periods of recession or economic uncertainty, we may not be able to maintain or increase our sales to existing customers, make sales to new customers, or maintain our earnings from operations as a percentage of net sales. As a result, our operating results may be adversely and materially affected by weak or downward trends in the United States or global economy.

The loss of key management and sales personnel could adversely affect our business, including our ability to obtain and secure accounts and generate sales.

Our success has and will continue to depend upon key management and sales personnel, many of whom would be difficult to replace. The loss of the services of key employees could have a material adverse effect on our business, including our ability to establish and maintain client relationships. Our future success will depend in large part upon our ability to attract and retain personnel with a variety of sales, operating and managerial skills.

Global credit conditions may increase our credit risks.

Most of our customers are extended credit terms which are approved by us internally. While we attempt to cover as much of our credit risks as possible, not all of our risks can be fully covered due to the countries we operate in or the current credit conditions. Such exposure may translate into losses should there be any adverse changes to the financial condition of customers.

We operate in an industry that is subject to significant fluctuations in operating results that may result in unexpected reductions in revenue and stock price volatility.

We operate in an industry that is subject to seasonal and operational fluctuations that can significantly impact our results from quarter to quarter. Factors that may influence our quarterly operating results include:

- The volume and timing of customer orders received during the quarter;
- The timing and magnitude of customers' marketing campaigns;
- The loss or addition of a major customer or of a major retailer nomination;
- The availability and pricing of materials for our products;
- The increased expenses incurred in connection with the introduction of new products;
  - Currency fluctuations;
- Political factors that may affect the expected flow of commerce;
  - Delays caused by third parties; and
- Changes in our product mix or in the relative contribution to sales of our subsidiaries.

Due to these factors, it is possible that in some quarters our operating results may be below our stockholders' expectations and those of public market analysts. If this occurs, the price of our common stock could be adversely affected.

Our products may not comply with various industry and governmental regulations and our customers may incur losses in their products or operations as a consequence of our non-compliance.

Our products are produced under strict supervision and controls to ensure that all materials and manufacturing processes comply with the industry and governmental regulations governing the markets in which these products are sold. However, if these controls fail to detect or prevent non-compliant materials from entering the manufacturing

process, our products could cause damages to our customer's products or processes and could also result in fines being incurred. The possible damages, replacement costs and fines could significantly exceed the value of our products and these risks may not be covered by our insurance policies.

If customers default on inventory purchase commitments with us, we may be left holding non-salable inventory.

We hold inventories for specific customer programs, which the customers have committed to purchase. If any customer defaults on these commitments, or insists on markdowns, we may incur a charge in connection with our holding non-salable inventory and this would have a negative impact on our operations and cash flow.

Because we depend on a limited number of suppliers, we may not be able to always obtain materials when we need them and we may lose sales and customers.

Lead times for materials we order can vary significantly and depend on many factors, including the specific supplier, the contract terms and the demand for particular materials at a given time. From time to time, we may experience fluctuations in the prices and disruptions in the supply of materials. Shortages or disruptions in the supply of materials, or our inability to procure materials from alternate sources at acceptable prices in a timely manner, could lead us to miss deadlines for orders and lose sales and customers.

Our customers have cyclical buying patterns which may cause us to have periods of low sales volume.

Most of our customers are in the apparel industry. The apparel industry historically has been subject to substantial cyclical variations. Our business has experienced significant cyclical fluctuations due, in part, to customer buying patterns, which may result in periods of low sales usually in the first and fourth quarters of our financial year. Backlogs of sales orders are not considered material in the industries in which we compete, which reduces the predictability of revenues and reinforces the volatility of these cyclical buying patterns on our sales volume.

If we experience disruptions at any of our foreign facilities, we will not be able to meet our obligations and may lose sales and customers.

Currently, we do not operate duplicate facilities in different geographic areas. Therefore, in the event of a regional disruption where we maintain one or more of our facilities, it is unlikely that we could shift our operations to a different geographic region and we may have to cease or curtail our operations in a selected area. This may cause us to lose sales and customers. The types of disruptions that may occur include:

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

Counterfeit products are not uncommon in the apparel industry and our customers may make claims against us for products we have not produced, adversely impacting us by these false claims.

Counterfeiting of valuable trade names is commonplace in the apparel industry and while there are industry organizations and federal laws designed to protect the brand owner, these counterfeit products are not always detected and it can be difficult to prove the manufacturing source of these products. Accordingly, we may be adversely affected if counterfeit products damage our relationships with customers, and we incur costs to prove these products are counterfeit, to defend ourselves against false claims and to pay for false claims.

On occasion, we have discovered that certain Asian factories had counterfeited Talon zippers. We undertake efforts to eliminate and prosecute all offenders. Counterfeiting of known quality brand products is commonplace within Asia and in particular where retailers limit their sources to recognized brands such as Talon. The full extent of counterfeiting of Talon products, its effect on our business operations and the costs to investigate and eliminate this activity are ongoing and are generally undeterminable. However, based upon evidence available, we believe the impact is not significant to our current overall operations. We continue to work closely with major retailers to identify these activities within the marketplace and will aggressively combat these efforts worldwide to protect the Talon brand.

Our business model is dependent on integration of information systems on a global basis and, to the extent that we fail to maintain and support our information systems, it can result in lost revenues.

We must consolidate and centralize the management of our subsidiaries and significantly expand and improve our financial and operating controls. Additionally, we must effectively integrate the information systems of our worldwide operations with the information systems of our principal offices in California. Our failure to do so could result in lost revenues, delay financial reporting or have adverse effects on the information reported.

Internet-based systems that we rely upon for our order tracking and management systems may experience disruptions and as a result we may lose revenues and customers.

To the extent that we fail to adequately update and maintain the hardware and software implementing our integrated systems, our customers may be delayed or interrupted due to defects in our hardware or our source code. In addition, since our software is Internet-based, interruptions in Internet service generally can negatively impact our ability to use our systems to monitor and manage various aspects of our customer's needs. Such defects or interruptions could result in lost revenues and lost customers.

The outcome of any dispute or litigation in which we have been named as a defendant is unpredictable and an adverse decision in any such matter could have a material adverse effect on our financial position and results of operations.

From time to time we are defendants in various disputes or litigation matters. These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made in each and all of the matters to which we have been named a party and we intend to contest each vigorously, no assurances can be given that the results of these matters will be favorable to us. We maintain product liability, errors and omissions, and director and officer insurance that we regard as reasonably adequate to protect us from potential claims; however, we cannot assure adequacy to cover any losses, or that we will be able to maintain our current levels of insurance at a reasonable cost or at all.

Unauthorized use of our proprietary technology may increase our litigation costs and adversely affect our sales.

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



If our products infringe any other person's proprietary rights, we may be sued and have to pay legal expenses and judgments and redesign or discontinue selling our products.

From time to time in our industry, third parties allege infringement of their proprietary rights. Any infringement claims, whether or not meritorious, could result in costly litigation or require us to enter into royalty or licensing agreements as a means of settlement. If we are found to have infringed the proprietary rights of others, we could be required to pay damages, cease sales of the infringing products and redesign the products or discontinue their sale. Any of these outcomes, individually or collectively, could have a material adverse effect on our operating results and financial condition.

We may not be able to realize the anticipated benefits of acquisitions.

We may consider strategic acquisitions as opportunities arise. Acquisitions involve numerous risks, including diversion of our management's attention away from our operating activities. We cannot assure you that we will not encounter unanticipated problems or liabilities relating to the integration of an acquired company's operations, nor can we assure you that we will realize the anticipated benefits of any future acquisitions.

Our actual tax liabilities may differ from estimated tax resulting in unfavorable adjustments to our future results.

The amount of income taxes we pay is subject to ongoing audits by federal, state and foreign tax authorities. Our estimate of the potential outcome of uncertain tax issues is subject to our assessment of relevant risks, facts and circumstances existing at that time. Our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, which may impact our effective tax rate and our financial results.

We have experienced and may continue to experience major fluctuations in the market price for our common stock.

The following factors could cause the market price of our common stock to decrease, perhaps substantially:

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

If we need to sell or issue additional shares of common stock or assume additional debt to finance future growth, our stockholders' ownership could be diluted or our earnings could be adversely impacted.

Our business strategy may include expansion through internal growth, by acquiring complementary businesses or by establishing strategic relationships with targeted customers and suppliers. In order to do so, or to fund our other activities, we may issue additional equity securities that could dilute our stockholders' value. We may also assume additional debt and incur impairment losses to our intangible assets if we acquire another company.

We have adopted a number of anti-takeover measures that may depress the price of our common stock.

Our stockholders' rights plan, our ability to issue additional shares of preferred stock and some provisions of our certificate of incorporation and bylaws and of Delaware law could make it more difficult for a third party to make an unsolicited takeover attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price.

CVC holds voting control of our outstanding voting securities, which could limit other stockholders' ability to influence the outcome of key transactions.

With our entry into the Recapitalization Agreement, we issued to CVC California LLC ("CVC") Series B Preferred Stock which upon conversion, when combined with the 1,750,000 shares of common stock already owned by CVC, represents 68.8% of our company's current outstanding voting securities as of December 31, 2011. As a result, CVC has the voting power to determine the outcome of any matter submitted to a vote of the holders of our common stock, including the election of a majority of the members of our Board of Directors and any change in control transaction. This concentration of ownership of our voting securities could have the effect of causing, delaying or preventing a change of control of our company or discouraging or preventing a potential acquirer from attempting to obtain control of our company. This, in turn, could have a negative effect on the market price of our common stock.

We may face interruption of production and services due to increased security measures in response to terrorism.

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

#### ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

Our headquarters are located in the greater Los Angeles area, in Woodland Hills, California. We lease approximately 11,477 square feet of office, warehouse and product development spaces in US and 36,038 square feet of office, warehouse, product development and showroom spaces in Asia. The lease agreements related to these properties expire at various dates through October 2014. We believe our existing facilities are adequate to meet our needs for the foreseeable future.

## ITEM 3. LEGAL PROCEEDINGS

On April 16, 2004, we originally filed suit against Pro-Fit Holdings, Limited in the U.S. District Court for the Central District of California – Tag-It Pacific, Inc. v. Pro-Fit Holdings, Limited, CV 04-2694 LGB (RCx) -- asserting various contractual and tort claims relating to our exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. Other related actions were subsequently filed by the parties. In 2008 Pro-Fit and certain related companies were placed into administration in the United Kingdom and filed petitions under Chapter 15 of Title 11 of the United States Code. Consequently, all litigation against Pro-Fit was stayed. In September 2011, we signed a Settlement Agreement and Release with Pro-Fit and the other parties involved in the litigation and administration proceedings. The Settlement Agreement provided for the unconditional release of Talon and related entities from all claims involved in the matter, a stipulation requesting that the US District Court dismiss the action, and our acquisition of all of the U.S. patents, licenses, rights and technology associated with our former exclusive license. The Settlement Agreement provides for no damages paid by any party and for dismissal of all actions with prejudice, and was formally completed by the parties in March 2012.

We currently have pending various other claims and complaints that arise in the ordinary course of our business. We believe that we have meritorious defenses to these claims and that the claims are either covered by insurance or would not have a material effect on our consolidated financial condition if adversely determined against us.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## PART II

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

## Common Stock

Our common stock is currently listed on the OTCQB under the trading symbol "TALN". Prior to February 22, 2011, our common stock had been quoted on the OTC Bulletin Board under the symbol "TALN" since December 28, 2007. The following table sets forth the high and low sales prices for the Common Stock as reported by the OTC Bulletin Board or the OTCQB during the periods indicated. Over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

|                              | High    | Low     |
|------------------------------|---------|---------|
| Year ended December 31, 2011 |         |         |
| 1st Quarter.                 | \$ 0.20 | \$ 0.09 |
| 2nd Quarter                  | 0.20    | 0.07    |
| 3rd Quarter                  | 0.16    | 0.09    |
| 4th Quarter                  | 0.13    | 0.04    |
| Year ended December 31, 2010 |         |         |
| 1st Quarter.                 | \$ 0.13 | \$ 0.05 |
| 2nd Quarter                  | 0.20    | 0.09    |
| 3rd Quarter                  | 0.25    | 0.11    |
| 4th Quarter                  | 0.19    | 0.09    |

On March 23, 2012 the closing sales price of our common stock as reported on the OTCQB was \$0.08 per share. As of March 23, 2012, there were 22 recorded holders of our common stock and approximately 82.5% of our outstanding shares were held by brokers and dealers.

## Dividends

We have never paid dividends on our common stock. We are restricted from paying dividends under our senior secured credit facility. It is our intention to retain future earnings for use in our business.

## ITEM 6. SELECTED FINANCIAL DATA

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

|  | (In thousands except per share data) |              |              |             |             |
|--|--------------------------------------|--------------|--------------|-------------|-------------|
|  | 2011                                 | 2010         | 2009         | 2008        | 2007        |
| <b>Consolidated Statement of Operations Data:</b>                      |                                      |              |              |             |             |
| Talon zippers net sales  | \$ 22,613                            | \$ 24,517    | \$ 21,341    | \$ 28,429   | \$ 21,160   |
| Trim net sales   | 19,048                               | 16,936       | 17,274       | 19,537      | 18,689      |
| Tekfit net sales   | 8                                    | 7            | 61           | 205         | 681         |
| Total net sales  | \$ 41,669                            | \$ 41,460    | \$ 38,676    | \$ 48,171   | \$ 40,530   |
| Income (loss) from operations (1)                                      | 1,339                                | \$ 1,471     | \$ 289       | \$ (5,962 ) | \$ (3,171 ) |
| Net income (loss) (2)  | \$ 729                               | \$ (1,467 )  | \$ (2,693 )  | \$ (8,359 ) | \$ (4,922 ) |
| Net income (loss) per share  | \$ 0.04                              | \$ (0.07 )   | \$ (0.13 )   | \$ (0.41 )  | \$ (0.24 )  |
| Basic and diluted net loss per share applicable to Common Shareholders | \$ (0.10 )                           | \$ (0.17 )   | \$ (0.13 )   | \$ (0.41 )  | \$ (0.24 )  |
| Weighted average shares outstanding – basic and diluted                | 20,568                               | 20,291       | 20,291       | 20,291      | 20,156      |
| <b>Consolidated Balance Sheet Data:</b>                                |                                      |              |              |             |             |
| Cash and cash equivalents  | \$ 5,749                             | \$ 2,795     | \$ 2,265     | \$ 2,400    | \$ 2,919    |
| Total assets   | \$ 16,358                            | \$ 13,828    | \$ 13,834    | \$ 15,603   | \$ 21,684   |
| Notes payable and capital lease obligations (2)                        | \$ 324                               | \$ 362       | \$ 15,270    | \$ 13,316   | \$ 12,696   |
| Series B Convertible Preferred Stock                                   | \$ 20,672                            | \$ 17,820    | \$ -         | \$ -        | \$ -        |
| Stockholders’ equity (Deficit)   | \$ (13,919 )                         | \$ (12,801 ) | \$ (11,179 ) | \$ (8,762 ) | \$ (717 )   |
| <b>Per Share Data:</b>   |                                      |              |              |             |             |
| Net book value per common share  | \$ (0.66 )                           | \$ (0.63 )   | \$ (0.55 )   | \$ (0.43 )  | \$ (0.04 )  |
| Common shares outstanding  | 21,001                               | 20,291       | 20,291       | 20,291      | 20,291      |

(1) Income (loss) from operations for each fiscal year includes the following items:

|                      | (In thousands) |      |      |           |          |
|----------------------|----------------|------|------|-----------|----------|
|                      | 2011           | 2010 | 2009 | 2008      | 2007     |
| Inventory Impairment | \$ -           | \$ - | \$ - | \$ (692 ) | \$ -     |
|                      | -              | -    | -    | (1,040 )  | (1,088 ) |

Losses from a former customer  
and impairment of related  
marketable securities

|  |      |        |           |             |             |
|--|------|--------|-----------|-------------|-------------|
| Executive severance                                    | -    | -      | -         | (724 )      | -           |
| Related party note receivable<br>recovery (impairment) | -    | 275    | (200 )    | (474 )      | -           |
| Prior years consulting fees                            | -    | -      | (201 )    | -           | -           |
| Impairment charges Idle<br>Equipment and Building      | -    | -      | -         | (2,430 )    | (127 )      |
| Combined   | \$ - | \$ 275 | \$ (401 ) | \$ (5,360 ) | \$ (1,215 ) |

(2) Loss on extinguishment of debt was included in the net loss for the year ended December 31, 2010 in amount of approximately \$571,000, see Note 5 in the accompanying Notes to Consolidated Financial Statements.

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

### Overview

This report and other documents we file with the Securities and Exchange Commission contain forward looking statements that are based on current expectations, estimates, forecasts and projections about us, our future performance, our business or others on our behalf, our beliefs and our management's assumptions. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. We describe our respective risks, uncertainties, and assumptions that could affect the outcome or results of operations below. We have based our forward looking statements on our management's beliefs and assumptions based on information available to our management at the time the statements are made. We caution you that actual outcomes and results may differ materially from what is expressed, implied, or forecast by our forward looking statements. Reference is made in particular to forward looking statements regarding projections or estimates concerning our business, including adequate liquidity to fund our operations and meet our other cash requirements, demand for our products and services, mix of revenue streams, ability to control or reduce operating expenses, anticipated gross margins and operating results, cost savings, product development efforts, general outlook of our business and industry, international businesses, and competitive position.

The following management's discussion and analysis is intended to assist the reader in understanding our consolidated financial statements. This management's discussion and analysis is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and accompanying notes. Amounts presented in this report are rounded to the nearest thousand dollars, except per share amounts.

Talon International, Inc. designs, manufactures, sells and distributes apparel zippers, specialty waistbands and various apparel trim products to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We sell and market these products under various branded names including Talon® and Tekfit®. We operate the business globally under three product groups.

We pursue the global expansion of our business through the establishment of Talon owned sales and distribution locations, and strategic manufacturing relationships. The manufacturing arrangements, in combination with Talon owned and affiliated facilities under the Talon brand, improve our time-to-market throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets.

Our primary business focus is on serving as an outsourced apparel zipper and trims supplier, product design and development, sampling and sourcing department for the most demanding brands and retailers. We believe that design differentiation among brands and retailers is a critical marketing tool for our customers. By assisting our customers in the design, development, sampling and sourcing of all trim components, we generally achieve higher margins for our products, create long-term relationships with our customers, grow our sales to a particular customer by serving a larger proportion of their brands and better differentiate our sales and services from those of our competitors. We are expanding our business globally, to better serve our apparel customers in the field, in addition to our brand and retail customer. We believe we can lead the industry in apparel accessories by having strong relationships with our brand and retail customers and having a distributed service organization to serve our factory customers globally.

Our Tekfit business provides manufacturers with the patented technology, manufacturing know-how, equipment and materials required to produce an expandable waistband. Our efforts to increase sales of this product have been limited by a licensing dispute. As described more fully in this report under Item 3. "Legal Proceedings", in March 2012 all parties involved in the dispute concluded a Settlement Agreement and Release that included an unconditional release of Talon and its related entities from all lawsuits, claims, liabilities, agreements, and contracts (among other potential

claims) involved in the matter.

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## Recapitalization

On July 30, 2010, we entered into a Recapitalization Agreement (the “Recapitalization Agreement”) with CVC California, LLC, pursuant to which we issued to CVC an aggregate of 407,160 shares of a newly created senior series of preferred stock, designated Series B Convertible Preferred Stock, in payment of an aggregate of \$16,707,000 owed by us to CVC under our Loan Agreement with CVC. Each share of Series B Preferred Stock is convertible into 100 shares of Common Stock. The Series B Preferred Stock has other rights, preferences, privileges and restrictions, including a liquidation preference, redemption rights and class voting rights, which are summarized in Note 5 in the accompanying Notes to Consolidated Financial Statements.

In connection with the Recapitalization Agreement our Board of Directors was reconfigured to consist of five members, with three members designated by the Series B Preferred Stockholders to serve as Series B Directors.

Concurrently with execution of the Recapitalization Agreement, we entered into a Stockholders Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of our Board of Directors, and Larry Dyne, our President, pursuant to which:

- CVC agreed that in connection with any director nominees to be submitted to holders of our common stock for election at a stockholders’ meeting, a committee of our Board comprised solely of directors then serving on the Board who were not elected or appointed by holders of Series B Preferred Stock, acting by majority vote, shall have the right to designate all of the Board’s nominees for director to be elected by holders of our Common Stock.
- CVC agreed that in connection with any election of directors submitted to our stockholders for election at a stockholders’ meeting, CVC will attend the stockholders’ meeting, in person or by proxy, and vote (or cause to be voted) all of CVC’s shares of our voting stock in favor of the Board’s nominees for director.
- Messrs. Schnell and Dyne provided CVC with a right of first refusal with respect to any shares of our voting securities that Messrs. Schnell and Dyne propose to sell in a private placement transaction, and agreed to provide CVC with advance notice of their intent to sell the Company’s voting securities in any public sale transaction.
- CVC provided Messrs. Schnell and Dyne with a tag-along right, providing Messrs. Schnell and Dyne with the right to sell their shares of our voting securities in a transaction where CVC is selling its shares of our voting securities.
- Messrs. Schnell and Dyne agreed with CVC to vote their shares of Talon voting stock in favor of a merger or consolidation of the company into or with another corporation or any share exchange, business combination or other such transaction in which we are a constituent party, or any sale of all or substantially all of our assets (a “Triggering Transaction”), in each case to the extent such transaction is first approved by CVC.
- CVC agreed not to sell or otherwise transfer its shares of our voting securities, or to vote its shares of the Company’s voting securities in favor of any Triggering Transaction, at any time on or before July 31, 2011, other than in connection with a transaction that is approved by a majority of our voting shares (where, in calculating such majority, the votes attributable to CVC’s shares of our voting securities are excluded in the numerator but included in the denominator).
- We provided CVC with a preemptive right, pursuant to which CVC will have the right, subject to certain exceptions set forth in the Stockholders Agreement, to acquire in a subsequent issuance of securities by us a number of offered securities that will allow CVC to maintain its percentage ownership of our voting securities.



- CVC agreed with Messrs. Schnell and Dyne that in connection with a Triggering Transaction, CVC, and any other holder of Series B Preferred Stock and shares of common stock acquired upon conversion thereof, shall pay to Messrs. Schnell and Dyne a portion (beginning at 5% and increasing to 10%) of the sales proceeds payable in the Triggering Transaction to CVC or such other holder in respect of such Series B Preferred Stock or conversion shares. Each of Messrs. Schnell and Dyne's right to receive such portion of the sales proceeds is conditional upon the Triggering Transaction occurring (i) while employed by the Company or (ii) within 12 months following termination of employment with the Company for any reason other than termination of employment for "cause" or termination of employment by Messrs. Schnell or Dyne without "good reason" (as such terms are defined in their respective employment agreements).

For further details on the transaction, see Notes 4 and 5 in the accompanying Notes to Consolidated Financial Statements.

## Results of Operations

### Net Sales

For the years ended December 31, 2011, 2010 and 2009, total sales by geographic region based on customer delivery locations were as follows:

|               | Year Ended December 31, |               |               |
|---------------|-------------------------|---------------|---------------|
|               | 2011                    | 2010          | 2009          |
| Sales:        |                         |               |               |
| United States | \$ 3,519,000            | \$ 3,574,000  | \$ 3,397,000  |
| Hong Kong     | 14,696,000              | 14,509,000    | 13,132,000    |
| China         | 9,558,000               | 10,412,000    | 8,991,000     |
| Bangladesh    | 2,093,000               | 2,547,000     | 2,009,000     |
| Other         | 11,803,000              | 10,418,000    | 11,147,000    |
| Total         | \$ 41,669,000           | \$ 41,460,000 | \$ 38,676,000 |

The net sales for the three primary product groups are as follows:

|                            | Year Ended December 31, |               |               |
|----------------------------|-------------------------|---------------|---------------|
|                            | 2011                    | 2010          | 2009          |
| Product Group Net Revenue: |                         |               |               |
| Talon zipper               | \$ 22,613,000           | \$ 24,517,000 | \$ 21,341,000 |
| Trim                       | 19,048,000              | 16,936,000    | 17,274,000    |
| Tekfit                     | 8,000                   | 7,000         | 61,000        |
| Total                      | \$ 41,669,000           | \$ 41,460,000 | \$ 38,676,000 |

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

Net sales for the year ended December 31, 2011 were \$41,669,000, a slight increase over the same period in 2010. The net increase mainly reflected sales to new customers and new programs within key customer accounts approximating \$7.1 million offset by a decline of approximately \$5.8 million in the sales of generic zippers to price sensitive mass merchandise and licensing customers who shifted their purchase to low-cost factories in Asia. The general economic weakness and increased commodity costs in the U.S. apparel market also resulted in lower unit demand for our products during the first half of 2011 compared to the first half of 2010.

Net sales for the year ended December 31, 2010 were \$41,460,000, an increase of \$2,784,000 or 7.2%, from the same period in 2009. The net increase reflected improved retail buying in the first half of 2010 and the replenishment of inventories in this period by major brands, in addition to the benefit of new programs and customers for our products.

#### Cost of goods sold and selected operating expenses

The following table summarizes cost of goods sold and selected operating expenses for the years ended December 31, 2011, 2010 and 2009 (amounts in thousands) and the percentage change in such operating expenses as compared to the previous year:

|                                    | 2011     | Change | 2010       | Change | 2009       |   |
|------------------------------------|----------|--------|------------|--------|------------|---|
| Sales                              | \$41,669 | 1      | % \$41,460 | 7      | % \$38,676 |   |
| Cost of goods sold                 | 28,465   | (2)    | % 28,999   | 6      | % 27,363   |   |
| % of sales                         | 68       | %      | 70         | %      | 71         | % |
| Sales and marketing expenses       | 4,261    | 40     | % 3,035    | 12     | % 2,713    |   |
| % of sales                         | 10       | %      | 7          | %      | 7          | % |
| General and administrative expense | \$7,604  | (4)    | % \$7,954  | (4)    | % \$8,311  |   |
| % of sales                         | 18       | %      | 19         | %      | 22         | % |

#### Cost of goods sold

Cost of goods sold for the year ended December 31, 2011 decreased \$535,000, resulting in a lowering of costs to 68% of sales versus 70% of sales for the year ended December 31, 2010. The reduction in the cost of goods sold evidenced approximately \$523,000 in lower direct costs associated with a greater mix of high margin (relatively lower cost) products in the Talon and the Trim Divisions, lower manufacturing support and inventory obsolescence costs and freight expenses of \$139,000, partially offset by added costs of \$127,000 associated with the overall sales volumes increase.

Cost of goods sold for the year ended December 31, 2010 increased \$1,636,000 from the prior year, for a decline to 70% of sales as compared to 71% of sales in the year ended December 31, 2009. The increase in the cost of goods sold reflected higher overall sales volumes impact of \$1,722,000 and higher manufacturing support and inventory obsolescence costs and freight expenses of \$102,000, partially offset by lower direct costs of \$188,000 associated with a greater mix of high margin products in the Talon and the Trim Divisions.

#### Sales and marketing expenses

Sales and marketing expenses for the year ended December 31, 2011 were \$4,261,000, or 10.2% of sales, as compared to \$3,035,000, or 7.3% of sales, for the same period in 2010. Sales expenses increased mainly due to a strategic expansion of our internal sales force and external sales representatives network in the US, Europe and Asia during 2011, in an effort to significantly expand our presence in select product markets within the U.S. Europe and Asia.



Sales and marketing expenses for the year ended December 31, 2010 were \$3,035,000, or 7.3% of sales, as compared to \$2,713,000, or 6.5% of sales, for the same period in 2009. Sales expenses increased due to the expansion of our sales force in the US during the third quarter of 2010 offset by lower sales force expenses in Asia.

#### General and administrative expenses

General and administrative expenses for the year ended December 31, 2011 were \$7,604,000, or 18.2% of sales, as compared with \$7,954,000, or 19.2% of sales, for the same period in 2010. The reduction of \$350,000 mainly reflects the expiration and settlement of 2007 and prior claims by previous suppliers to our discontinued Mexico operations totaling \$381,000, lower professional fees and facilities expenses of \$368,000 and lower depreciation expenses of \$209,000 offset by increased charges for non-cash compensation expenses of \$340,000 and the beneficial effect of the sale of a note of \$275,000 recorded in 2010.

General and administrative expenses for the year ended December 31, 2010 were \$7,954,000, or 19% of sales, as compared with \$8,311,000, or 22% of sales, for the same period in 2009. The \$357,000 reduction mainly reflects the beneficial effect of the sale of the Note Receivable from Related party of \$275,000, other reductions to the allowance for doubtful accounts of \$428,000, reduced professional fees of \$664,000, and a net reduction of samples, travel expenses and facilities expense of \$214,000. The costs reductions were substantially offset by increased employee expenses \$819,000 and increased non-cash compensation and depreciation expenses of \$405,000.

#### Interest expense and interest income

Interest expense for the year ended December 31, 2011 decreased by \$1,675,000 or 93% to \$128,000, as compared to interest expense of \$1,803,000 in 2010. The decrease was the result of the elimination of amounts owed under our former revolving credit line and term notes with CVC that were converted into preferred stock as of July 30, 2010. (See Note 4 in the accompanying Notes to Consolidated Financial Statements). Interest income for the year ended December 31, 2011 decreased by \$27,000 as compared to \$31,000 in 2010 primarily due to the recognition of and collection of interest income on the related party note receivable in 2010, which we sold to a third party (See Note 12 in the accompanying Notes to Consolidated Financial Statements).

Interest expense for the year ended December 31, 2010 decreased by \$993,000 or 33% to \$1,803,000, as compared to \$2,735,000 in 2009. The decrease was the result of the elimination of amounts owed under our former revolving credit line and term notes with CVC that were converted into preferred stock as of July 30, 2010. (See Note 4 in the accompanying Notes to Consolidated Financial Statements). Interest income for the year ended December 31, 2010 increased by \$23,000 as compared to \$8,000 in 2009 primarily due to the recognition of and collection of interest income on the related party note receivable (See Note 12 in the accompanying Notes to Consolidated Financial Statements).

#### Loss on extinguishment of debt

Loss on extinguishment of debt in the amount of \$571,000 was recorded during the year ended December 31, 2010 as a result of the transactions pursuant to the Recapitalization Agreement between us and our lender. See Note 5 in the accompanying Notes to Consolidated Financial Statements. There was no loss on extinguishment of debt for the 2011 and 2009 fiscal years.

## Income taxes

Provision for income taxes for the year ended December 31, 2011 was \$486,000, which included a U.S. charge for foreign taxes arising from intellectual property charges to our foreign operations, a China charge for foreign taxes arising from China service fees to our operation in Hong Kong, a tax provision for Hong Kong operations offset by lower deferred tax assets in Hong Kong, and a U.S. tax basis difference related to our indefinite lived intangible asset. There is not sufficient evidence to determine that it is more likely than not that we will be able to utilize our net operating loss carry forwards to offset future taxable income and as a result, these deferred tax assets have a full valuation reserve applied against them.

Provision for income taxes for the year ended December 31, 2010 was approximately \$596,000. During the year ended December 31, 2010 we recorded a deferred income tax liability in the amount of approximately \$609,000 due to a tax basis difference related to our indefinite lived intangible asset, following our determination during the third quarter of 2010 that we would no longer be able to support the use of the deferred tax asset related to net operating losses to offset the liability (See Note 8 in the accompanying Notes to Consolidated Financial Statements). The net tax benefit from income taxes other than this deferred income tax liability is mainly associated with our foreign operations. There is not sufficient evidence to ensure that it is more likely than not that we will be able to utilize our domestic operating loss carry forwards (as well as a portion of our foreign net operating loss carry forwards) to offset future taxable income and consequently the tax benefit of these losses are offset by a full valuation reserve provided against them.

Provision for income taxes was approximately \$254,000 in 2009, which includes a charge for foreign withholding taxes arising from our domestic royalty charges to our foreign operations, domestic state income taxes, tax provision for our profitable operations in Hong Kong offset by adjustments to deferred tax assets in Hong Kong and India. There is not sufficient evidence to determine that it is more likely than not that we will be able to utilize its domestic and part of our foreign net operating loss carry forwards to offset future taxable income and as a result, these losses have a full valuation reserve against them.

## Liquidity and Capital Resources

The following table summarizes selected financial data at:

|                                  | December 31,<br>2011 | December 31,<br>2010 |
|----------------------------------|----------------------|----------------------|
| Cash and cash equivalents        | \$ 5,749,000         | \$ 2,795,000         |
| Total assets                     | \$ 16,358,000        | \$ 13,828,000        |
| Current liabilities              | \$ 8,464,000         | \$ 7,442,000         |
| Long term liabilities            | \$ 1,141,000         | \$ 1,367,000         |
| Preferred Stock                  | \$ 20,672,000        | \$ 17,820,000        |
| Stockholders' Equity (Deficit)   | \$ (13,919,000)      | \$ (12,801,000)      |
| Total Equity and Preferred Stock | \$ 6,753,000         | \$ 5,019,000         |

We believe that our existing cash and cash equivalents and our anticipated cash flows from our operating activities will be sufficient to fund our minimum working capital and capital expenditure needs for operating activities for at least the next twelve months.



## Cash and cash equivalents

Most of our cash is held with financial institutions. Substantially all of the balances at December 31, 2011 and 2010 are in excess of federally insured limits, and there is no restricted cash. During 2009 and 2010 we had pledged cash of \$260,924 as a compensating balance in a legal dispute with a trade supplier in China. During 2011, the pledge was eliminated upon settlement of the dispute.

Cash and cash equivalents increased by \$2,954,000 at December 31, 2011 as compared to December 31, 2010, principally due to net cash provided by operating activities partially offset by the acquisition of property and equipment and payment of notes payable to related parties.

Cash and cash equivalents increased by \$531,000 at December 31, 2010 as compared to December 31, 2009, principally due to net cash provided by operating activities offset by net cash used in financing activities related to preferred stock issuance costs incurred as part of the Recapitalization Agreement and the payment of loan modification fees (pursuant to Amendment No. 6 of the Loan Agreement dated July 30, 2010).

## Cash flows

The following table summarizes our cash flow activity for the years ended December 31, 2011, 2010 and 2009:

|  | Year Ended December 31, |            |               |
|--|-------------------------|------------|---------------|
|  | 2011                    | 2010       | 2009          |
| Net cash provided by operating activities            | \$ 3,042,000            | \$ 940,000 | \$ 186,000    |
| Net cash used in investing activities                | (118,000 )              | (89,000 )  | (487,000 )    |
| Net cash provided by (used in) financing activities  | (39,000 )               | (305,000 ) | 193,000       |
| Net effect of foreign currency translation on cash   | 69,000                  | (15,000 )  | (27,000 )     |
| Net increase (decrease) in cash and cash equivalents | \$ 2,954,000            | \$ 531,000 | \$ (135,000 ) |

## Operating Activities

The net cash provided by operating activities is our primary recurring source of funds, and reflects net income from operations excluding non cash charges and changes in operating capital. The net cash provided by operating activities during the years ended December 31, 2011, 2010 and 2009 resulted principally from:

|                                     | Year Ended December 31, |              |            |
|-------------------------------------|-------------------------|--------------|------------|
|                                     | 2011                    | 2010         | 2009       |
| Net income before non-cash expenses | \$ 2,521,000            | \$ 1,690,000 | \$ 312,000 |
| Inventory reduction                 | 231,000                 | 301,000      | 722,000    |
|                                     | (392,000 )              | 65,000       | (71,000 )  |

|   |              |            |              |
|---|--------------|------------|--------------|
| Accounts receivable<br>reduction (increase)                         |              |            |              |
| Accounts payable<br>and accrued<br>expenses increase<br>(reduction) | 1,002,000    | (963,000 ) | (1,014,000 ) |
| Other increases<br>(reductions) in<br>operating capital             | (320,000 )   | (153,000 ) | 237,000      |
| Cash provided by<br>operating activities                            | \$ 3,042,000 | \$ 940,000 | \$ 186,000   |

## Investing Activities

Net cash used in investing activities for the year ended December 31, 2011 was \$118,000 primarily for the acquisition of property and equipment of \$173,000, offset by proceeds from the sale of equipment in the amount of \$55,000.

Net cash used in investing activities for the year ended December 31, 2010 was \$89,000 resulting mainly from the acquisition of property and equipment of \$91,000 partially offset by proceeds from the sale of equipment held for sale in the amount of approximately \$2,000.

Net cash used in investing activities for the year ended December 31, 2009 was \$487,000 resulting in expenditures totaling \$543,000 principally associated with the development of our new ERP system that was implemented in March 2009, leasehold improvements for our new facility in China, and proceeds from sale of equipment mainly associated with equipment held for sale as of December 31, 2008.

#### Financing Activities

Net cash used in financing activities for the year ended December 31, 2011 was \$39,000, reflecting payment of a note payable to related parties in the amount of \$45,000 and repayment of borrowings under capital leases of \$6,000, offset by proceeds from the exercise of stock options in the amount of \$12,000.

Net cash used in financing activities for the year ended December 31, 2010 was \$305,000 and reflects preferred stock issuance costs, payment of loan modification fees and repayment of borrowings under capital leases.

Net cash provided in financing activities for the year ended December 31, 2009 was \$193,000 and primarily reflects additional borrowings under our revolver line of credit, offset by the repayment of borrowings under capital leases and notes payable.

On June 27, 2007, we entered into a Revolving Credit and Term Loan Agreement (the "Loan Agreement") with Bluefin Capital, LLC that provided for a \$5.0 million revolving credit facility and a \$9.5 million term loan, each with a three year term maturing June 30, 2010. Bluefin Capital subsequently assigned its rights and obligations under the Loan Agreement to an affiliate, CVC. Borrowings under the Loan Agreement are secured by all of our assets.

On June 30, 2010 the Loan Agreement was amended to extend the existing maturity date for an additional thirty days to July 30, 2010. The Loan Agreement (as amended) was scheduled to mature July 30, 2010 and all of the principal and interest arising under the Loan Agreement in the approximate amount of \$16,707,000 was due. We did not have sufficient resources to pay this obligation on the maturity date, and entered into the Recapitalization Agreement in settlement of this debt.

On July 30, 2010, we entered into a Recapitalization Agreement in which we issued to CVC shares of Series B Preferred Stock in payment of all of the outstanding obligations owed by us under the Loan Agreement. At that date, we had outstanding borrowings and accrued interest of \$11,548,000 under the term notes and \$5,159,000 under the revolving credit note, all of which was exchanged for the Series B Preferred Stock. See Note 5 in the accompanying Notes to Consolidated Financial Statements.

In connection with the Recapitalization Agreement, we amended the Loan Agreement to extend the maturity date of the Loan Agreement from July 30, 2010 until July 31, 2012, reduce the maximum borrowings available under the Revolver to \$3,000,000, amend the borrowing base to modify the advance rate applicable to eligible accounts receivable to 75% and modify the advance rate applicable to eligible inventory to 40%, eliminate loan maintenance fees, and modify the permissible amount of capital expenditures we can make in any fiscal year. The current financial covenants continue to exist through the maturity date. We paid CVC a non-refundable fee in the amount of \$60,000 in consideration of CVC entering into the amendment and paid a \$50,000 commitment fee during the third quarter of 2011 to ensure the availability of the revolver through July 31, 2012. Upon execution of the amendment, CVC waived all prior events of default under the Loan Agreement.



At December 31, 2011 and 2010, there were no borrowings under the revolving credit facility portion of the Loan Agreement, no term loans under the Loan Agreement and we were in compliance with all loan covenants.

We have financed equipment purchases through various notes payable and capital lease obligations. Our equipment obligations as of December 31, 2010 are approximately \$24,000 and bear interest at rates of 8.0% and 15.4% per annum. Under these obligations, we are required to make monthly payments of principal and interest through June 2014.

The outstanding balance (including accrued interest) of our notes payable to related parties at December 31, 2011 and December 31, 2010 was \$240,000 and \$275,000, respectively. Included in the balance at December 31, 2010 were two demand notes totaling \$236,000 which bore interest at 10%, had no scheduled monthly payments and were due within fifteen days following demand. On August 2, 2011 one of the demand notes was paid in full, including accrued interest, for \$44,340. As of December 31, 2011 the remaining demand note totaled \$199,000, and subsequent to this date it was paid in full. The balance of the notes payable to related parties represents our note payable to an officer for \$41,000 and \$39,000 at December 31, 2011 and 2010, respectively. The note bore 6% interest annually and was paid in full in accordance with its terms subsequent to the year ending December 31, 2011.

We have satisfied our working capital requirements primarily through cash flows generated from operations and borrowings under our credit facility. As we continue to expand globally with our apparel manufacturing in offshore locations, our customers are substantially all foreign-based and foreign-owned entities. We continue to evaluate both financing and equity options to provide capital if needed to fund our expansion and on-going operations. If we experience greater than anticipated reductions in sales, we may need to borrow or raise additional capital, or further reduce the scope of our business in order to fund our on-going operations or to satisfy our future short-term operating requirements. The extent of our future long-term capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of possible acquisitions, our borrowing base availability limitations and our expansion into foreign markets. Our need for additional long-term financing may include the integration and expansion of our operations to exploit our rights under our Talon trade name, and the expansion of our operations in the Asian and European markets. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise additional debt or equity financing in order to provide for our operations.

#### Contractual Obligations

The following summarizes our contractual obligations at December 31, 2011 and the effects such obligations are expected to have on liquidity and cash flow in future periods:

| Contractual Obligations          | Total               | Payments Due by Period |                   |              |                  |
|----------------------------------|---------------------|------------------------|-------------------|--------------|------------------|
|                                  |                     | Less than<br>1 Year    | 1-3<br>Years      | 4-5<br>Years | After<br>5 Years |
| Notes payable to related parties | \$ 240,000          | \$ 240,000             | \$ -              | \$ -         | \$ -             |
| Other notes payable              | 66,000              | 66,000                 | -                 | -            | -                |
| Capital lease obligations        | 21,000              | 9,000                  | 12,000            | -            | -                |
| Operating leases                 | 940,000             | 519,000                | 421,000           | -            | -                |
| <b>Total Obligations</b>         | <b>\$ 1,267,000</b> | <b>\$ 834,000</b>      | <b>\$ 433,000</b> | <b>\$ -</b>  | <b>\$ -</b>      |

(1)

The majority of notes payable to related parties are due upon or within a short period after demand for payment and includes accrued interest payable through December 31, 2011. These notes were fully paid during the first quarter of 2012.

### Off-Balance Sheet Arrangements

At December 31, 2011 and 2010, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

### Related Party Transactions

For a description of certain transactions to which we were or will be a party, and in which any director, executive officer, or shareholder of more than 5% of our common stock or any member of their immediate family had or will have a direct or indirect material interest, see Item 13, "Certain Relationships and Related Transactions and Director Independence," of this Report.

### Application of Critical Accounting Policies and Estimates

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

Critical accounting policies are those that are important to the portrayal of our financial condition and results of operations, and which require us to make difficult, subjective and/or complex judgments. Critical accounting policies cover accounting matters that are inherently uncertain because the future resolution of such matters is unknown. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our Consolidated Financial Statements:

- Accounts receivable balances are evaluated on a continual basis and allowances are provided for potentially uncollectible accounts based on management's estimate of the collectability of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of its ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known. The bad debt expenses, recoveries and allowances for the years ended December 31, 2011, 2010 and 2009 are as follows:

|  | Year ended December 31, |               |            |
|--|-------------------------|---------------|------------|
|  | 2011                    | 2010          | 2009       |
| Bad debt expense (recovery), related party note receivable | \$ -                    | \$ (275,000 ) | \$ 200,000 |
| Bad debt expense (recovery), other accounts receivable     | \$ 28,000               | \$ (109,000 ) | \$ 120,000 |
| Allowance for doubtful accounts, Accounts receivable       | \$ 53,000               | \$ 133,000    | \$ 232,000 |

|   |      |      |            |
|---|------|------|------------|
| Allowance for doubtful<br>accounts, Related party | \$ - | \$ - | \$ 740,000 |
|---|------|------|------------|

- Inventories are stated at the lower of cost, determined using the first-in, first-out basis or market value and are all substantially finished goods. The costs of inventory include the purchase price, inbound freight and duties, conversion costs and certain allocated production overhead costs. Inventory is evaluated on a continual basis and reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Inventory reserves are recorded for damaged, obsolete, excess, impaired and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory.

Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory.

The inventory valuations provisions and allowances for inventory valuation reserves for the years ended December 31, 2011, 2010 and 2009 are as follows. The net recovery in 2011 resulted mainly due to sale of legacy zippers held in inventory:

|  | Year Ended December 31, |            |              |
|--|-------------------------|------------|--------------|
|  | 2011                    | 2010       | 2009         |
| Inventory valuation provisions (recovery), net | \$ (36,000 )            | \$ 106,000 | \$ 61,000    |
| Allowance for inventory valuation reserves     | \$ 485,000              | \$ 884,000 | \$ 1,185,000 |

- We record deferred tax assets and liabilities arising from temporary timing differences between recorded net income and taxable net income when and if we believe that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. If we determine that we may not realize all of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. A deferred income tax liability related to indefinite lived intangibles should not be offset against deferred income tax assets.

We believe that our estimate of deferred tax assets and liabilities and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. See Note 8 in the accompanying Notes to Consolidated Financial Statements.

- We record impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value.

- Sales are recognized when persuasive evidence of an arrangement exists, product title has passed, pricing is fixed or determinable and collection is reasonably assured. Sales resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns and the cost of products sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances, which returns have been insignificant.
- We are currently involved in various lawsuits, claims and inquiries, most of which are routine to the nature of the business and in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") No 450, "Contingencies", we accrue estimates of the probable and estimable losses for the resolution of these claims. The ultimate resolution of these claims could affect our future results of operations for any particular quarterly or annual period should our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued.

#### New Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" ("ASU 2011-04") which amends ASC Topic 820, Fair Value Measurement. ASU 2011-04 changes the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The update clarifies the application of existing fair value measurement requirements. The update also requires reporting entities to disclose additional information regarding fair value measurements categorized within Level 3 of the fair value hierarchy. ASU 2011-04 is effective during interim and annual period beginning after December 15, 2011. Early adoption is not permitted. The adoption of this guidance will not have any impact on our results of operations and financial condition.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income" ("ASU 2011-05") which amends ASC Topic 220, Comprehensive Income. ASU 2011-05 gives an entity the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance in ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not have any impact on our results of operations or financial condition.

In September 2011, the FASB issued ASU 2011-08, "Intangibles – Goodwill and Other (Topic 350) — Testing Goodwill for Impairment". This amendment allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative impairment test. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 and early adoption is permitted. We don't expect to have an impact on our financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220)". The amendments in this Update supersede certain pending paragraphs in ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, to effectively defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments will be temporary to allow the Board time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. ASU 2011-12 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not have any impact on our results of operations or financial condition.



ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

All of our sales are denominated in United States dollars or the currency of the country in which our products originate. We are exposed to market risk for fluctuations in the foreign currency exchange rates for certain product purchases that are denominated in Hong Kong dollars and Chinese Yuan. We do not intend to purchase contracts to hedge the exchange exposure for future product purchases. There were no hedging contracts outstanding as of December 31, 2011. Currency fluctuations can increase the price of our products to foreign customers which can adversely impact the level of our export sales from time to time. The majority of our cash equivalents are held in United States dollars in various bank accounts and we do not believe we have significant market risk exposure with regard to our investments.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Talon International, Inc.  
Woodland Hills, California

We have audited the accompanying consolidated balance sheets of Talon International, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2011. Our audits also included the financial statement schedule of Talon International, Inc. and subsidiaries, listed in Item 15(a). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Talon International, Inc. and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ SingerLewak LLP  
SingerLewak LLP  
Los Angeles, California  
March 26, 2012

## TALON INTERNATIONAL, INC.

## CONSOLIDATED BALANCE SHEETS

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| Assets  |                      |                      |
| Current assets:   |                      |                      |
| Cash and cash equivalents   | \$ 5,749,341         | \$ 2,795,284         |
| Accounts receivable, net  | 3,777,771            | 3,350,935            |
| Inventories, net  | 1,076,522            | 1,271,991            |
| Prepaid expenses and other current assets   | 314,761              | 331,924              |
| Total current assets  | 10,918,395           | 7,750,134            |
| Property and equipment, net   | 1,092,609            | 1,582,327            |
| Intangible assets, net  | 4,110,751            | 4,110,751            |
| Other assets  | 236,411              | 384,455              |
| Total assets  | \$ 16,358,166        | \$ 13,827,667        |
| Liabilities, Preferred Stock and Stockholders' Equity (Deficit)   |                      |                      |
| Current liabilities:  |                      |                      |
| Accounts payable  | \$ 6,607,041         | \$ 5,231,036         |
| Accrued expenses  | 1,543,465            | 1,865,841            |
| Notes payable to related parties  | 239,942              | 275,215              |
| Other notes and current portion of capital lease obligations  | 73,148               | 69,608               |
| Total current liabilities   | 8,463,596            | 7,441,700            |
| Capital lease obligations, net of current portion   | 10,461               | 17,492               |
| Deferred income taxes   | 751,148              | 608,554              |
| Other liabilities   | 379,803              | 740,877              |
| Total liabilities   | 9,605,008            | 8,808,623            |
| Commitments and contingencies (Note 9)  |                      |                      |
| Series B Convertible Preferred Stock, \$0.001 par value; 407,160 shares authorized, issued and outstanding  | 20,671,738           | 17,820,464           |
| Stockholders' Equity (Deficit):   |                      |                      |
| Series A Preferred Stock, \$0.001 par value; 250,000 shares authorized; no shares issued or outstanding   | -                    | -                    |
| Common Stock, \$0.01 par value, 100,000,000 shares authorized; 21,000,808 and 20,291,433 shares issued and outstanding at December 31, 2011 and December 31, 2010, respectively | 21,001               | 20,291               |
| Additional paid-in capital  | 57,948,111           | 56,975,314           |
| Accumulated deficit   | (71,949,921 )        | (69,827,780 )        |
| Accumulated other comprehensive income  | 62,229               | 30,755               |
| Total stockholders' equity (deficit)  | (13,918,580 )        | (12,801,420 )        |

|   |    |            |    |            |
|---|----|------------|----|------------|
| Total liabilities, preferred stock and stockholders' equity (deficit) | \$ | 16,358,166 | \$ | 13,827,667 |
|---|----|------------|----|------------|

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

|  | Year Ended December 31, |                 |                 |
|--|-------------------------|-----------------|-----------------|
|  | 2011                    | 2010            | 2009            |
| Net sales  | \$ 41,668,507           | \$ 41,459,747   | \$ 38,675,790   |
| Cost of goods sold   | 28,464,741              | 28,999,355      | 27,363,216      |
| Gross profit   | 13,203,766              | 12,460,392      | 11,312,574      |
| Sales and marketing expenses   | 4,260,609               | 3,035,228       | 2,712,814       |
| General and administrative expenses                                      | 7,603,909               | 7,953,756       | 8,310,684       |
| Total operating expenses   | 11,864,518              | 10,988,984      | 11,023,498      |
| Income from operations   | 1,339,248               | 1,471,408       | 289,076         |
| Interest expense, net  | 123,998                 | 1,771,662       | 2,727,919       |
| Loss on extinguishment of debt   | -                       | 570,915         | -               |
| Income (loss) before provision for income taxes                          | 1,215,250               | (871,169 )      | (2,438,843 )    |
| Provision for income taxes   | 486,117                 | 595,651         | 254,134         |
| Net income (loss)  | \$ 729,133              | \$ (1,466,820 ) | \$ (2,692,977 ) |
| Available to Preferred Shareholders:                                     |                         |                 |                 |
| Series B Preferred Stock Original Issue Discount                         | -                       | (903,172 )      | -               |
| Series B Preferred Stock Liquidation Preference Increase                 | (2,851,274 )            | (1,113,779 )    | -               |
| Loss applicable to Common Shareholders                                   | \$ (2,122,141 )         | \$ (3,483,771 ) | \$ (2,692,977 ) |
| Per share amounts:   |                         |                 |                 |
| Net income (loss) per share  | \$ 0.04                 | \$ (0.07 )      | \$ (0.13 )      |
| Available to Preferred Shareholders                                      | (0.14 )                 | (0.10 )         | -               |
| Basic and diluted net loss per share applicable to Common Shareholders   | \$ (0.10 )              | \$ (0.17 )      | \$ (0.13 )      |
| Weighted average number of common shares outstanding - Basic and diluted | 20,567,640              | 20,291,433      | 20,291,433      |

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)  
YEARS ENDED DECEMBER 31, 2011, 2010 AND 2009

|  | Common Stock |          | Preferred Stock Series A |        | Additional Paid-In Capital | Other Comprehensive Income (losses) | Accumulated Deficit | Total          |
|--|--------------|----------|--------------------------|--------|----------------------------|-------------------------------------|---------------------|----------------|
|  | Shares       | Amount   | Shares                   | Amount |                            |                                     |                     |                |
| Balance, January 1, 2009                                 | 20,291,433   | \$20,291 | -                        | \$-    | \$54,769,072               | \$ 99,737                           | \$(63,651,032)      | \$(8,761,932 ) |
| Stock based compensation                                 |              |          |                          |        | 301,496                    |                                     |                     | 301,496        |
| Foreign currency translation                             |              |          |                          |        |                            | (25,448 )                           |                     | (25,448 )      |
| Net loss   |              |          |                          |        |                            |                                     | (2,692,977 )        | (2,692,977 )   |
| Balance, December 31, 2009                               | 20,291,433   | 20,291   | -                        | -      | 55,070,568                 | 74,289                              | (66,344,009)        | (11,178,861)   |
| Stock based compensation                                 |              |          |                          |        | 621,403                    |                                     |                     | 621,403        |
| Foreign currency translation                             |              |          |                          |        |                            | (43,534 )                           |                     | (43,534 )      |
| Series B Preferred Stock Beneficial Conversion Feature   |              |          |                          |        | 1,283,343                  |                                     |                     | 1,283,343      |
| Series B Preferred Stock original issue discount         |              |          |                          |        |                            |                                     | (903,172 )          | (903,172 )     |
| Series B Preferred Stock Liquidation Preference Increase |              |          |                          |        |                            |                                     | (1,113,779 )        | (1,113,779 )   |
| Net loss   |              |          |                          |        |                            |                                     | (1,466,820 )        | (1,466,820 )   |
| Balance, December 31, 2010                               | 20,291,433   | 20,291   | -                        | -      | 56,975,314                 | 30,755                              | (69,827,780)        | (12,801,420)   |
| Stock based compensation                                 |              |          |                          |        | 961,477                    |                                     |                     | 961,477        |
| Foreign currency translation                             |              |          |                          |        |                            | 31,474                              |                     | 31,474         |
| Exercise of stock options                                | 109,375      | 110      |                          |        | 11,920                     |                                     |                     | 12,030         |
| RSU's settlement in Common Stock                         | 600,000      | 600      |                          |        | (600 )                     |                                     |                     | -              |

|  |            |          |   |     |              |              |                               |
|--|------------|----------|---|-----|--------------|--------------|-------------------------------|
| Series B Preferred Stock Liquidation Preference Increase |            |          |   |     |              | (2,851,274 ) | (2,851,274 )                  |
| Net income   |            |          |   |     |              | 729,133      | 729,133                       |
| Balance, December 31, 2011                               | 21,000,808 | \$21,001 | - | \$- | \$57,948,111 | \$ 62,229    | \$(71,949,921) \$(13,918,580) |

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Year Ended December 31, |                |                |
|--|-------------------------|----------------|----------------|
|  | 2011                    | 2010           | 2009           |
| Cash flows from operating activities:  |                         |                |                |
| Net income (loss)  | \$ 729,133              | \$(1,466,820 ) | \$(2,692,977 ) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                         |                |                |
| Depreciation and amortization  | 605,987                 | 793,603        | 725,979        |
| Loss (gain) on disposal of equipment   | (38,976 )               | -              | 5,462          |
| Loss on extinguishment of debt   | -                       | 570,915        | -              |
| Amortization of deferred financing cost and debt discounts                               | 30,000                  | 861,596        | 1,462,563      |
| Stock based compensation   | 961,477                 | 621,403        | 301,496        |
| Deferred income taxes, net   | 240,686                 | 586,664        | 128,726        |
| Bad debt expense (recovery), related party note receivable                               | -                       | (275,000 )     | 200,000        |
| Bad debt expense (recovery), other accounts receivable                                   | 28,350                  | (108,797 )     | 119,685        |
| Inventory valuation provisions (recovery), net   | (35,824 )               | 106,169        | 60,612         |
| Changes in operating assets and liabilities:   |                         |                |                |
| Accounts receivable  | (391,920 )              | 65,131         | 721,841        |
| Inventories  | 231,293                 | 301,142        | (70,768 )      |
| Prepaid expenses and other current assets  | 19,079                  | (89,558 )      | 234,340        |
| Other assets.  | 21,415                  | (77,070 )      | 36,887         |
| Accounts payable and accrued expenses  | 1,001,978               | (963,416 )     | (1,013,856 )   |
| Other liabilities  | (361,074 )              | 14,002         | (34,100 )      |
| Net cash provided by operating activities  | 3,041,604               | 939,964        | 185,890        |
| Cash flows from investing activities:  |                         |                |                |
| Proceeds from sale of equipment  | 55,000                  | 2,609          | 56,058         |
| Acquisitions of property and equipment   | (173,401 )              | (91,285 )      | (543,117 )     |
| Net cash used in investing activities  | (118,401 )              | (88,676 )      | (487,059 )     |
| Cash flows from financing activities:  |                         |                |                |
| Proceeds from exercise of stock options  | 12,030                  | -              | -              |
| Payment of capital leases  | (6,011 )                | (54,233 )      | (138,101 )     |
| Preferred stock issuance costs   | -                       | (190,744 )     | -              |
| Payment of revolver fees - financing costs   | -                       | (60,000 )      | -              |
| Revolver note borrowings   | -                       | -              | 350,000        |
| Term note borrowings, net of issuance costs  | -                       | -              | 125,000        |
| Payment of note payable to related parties   | (44,340 )               | -              | -              |
| Payment of notes payable   | -                       | -              | (144,064 )     |
| Net cash (used in) provided by financing activities                                      | (38,321 )               | (304,977 )     | 192,835        |
| Net effect of foreign currency exchange translation on cash                              | 69,175                  | (15,633 )      | (26,777 )      |
| Net increase (decrease) in cash and cash equivalents                                     | 2,954,057               | 530,678        | (135,111 )     |
| Cash and cash equivalents at beginning of period   | 2,795,284               | 2,264,606      | 2,399,717      |
| Cash and cash equivalents at end of period   | \$ 5,749,341            | \$ 2,795,284   | \$ 2,264,606   |

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | Year Ended December 31, |                |                |
|---|-------------------------|----------------|----------------|
|   | 2011                    | 2010           | 2009           |
| Supplemental disclosures of cash flow information:            |                         |                |                |
| Cash received (paid) during the period for:                   |                         |                |                |
| Interest paid   | \$(119,951 )            | \$(404,306 )   | \$(1,019,708 ) |
| Interest received   | \$4,190                 | \$30,841       | \$1,675        |
| Income tax paid, net (principally foreign)                    | \$(140,148 )            | \$(97,132 )    | \$(91,136 )    |
| Non-cash financing activities:                                |                         |                |                |
| Conversion of revolver and term notes to preferred stock      | \$-                     | \$16,706,685   | \$-            |
| Beneficial conversion feature for issuance of preferred stock | \$-                     | \$(1,283,343 ) | \$-            |
| Series B preferred stock original issue discount              | \$-                     | \$903,172      | \$-            |
| Series B preferred stock liquidation preference increase      | \$2,851,274             | \$1,113,779    | \$-            |
| RSU's settlement in common stock                              | \$600                   | \$-            | \$-            |
| Note payable issued for executive bonus earned                | \$-                     | \$-            | \$35,000       |
| Debt waiver, modification fee and interest                    | \$11,587                | \$11,864       | \$236,337      |
| Capital lease obligation                                      | \$-                     | \$-            | \$31,450       |
| Effect of foreign currency translation on net assets          | \$31,474                | \$(43,534 )    | \$(25,448 )    |
| Non-cash investing activity:                                  |                         |                |                |
| Equipment exchanged for dyeing services                       | \$46,368                | \$-            | \$-            |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Talon International, Inc. (together with its subsidiaries, the “Company”) is an apparel company that specializes in the distribution of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. The Company acts as a full service outsourced trim management department for manufacturers, a specified supplier of trim items to owners of specific brands, brand licensees and retailers, a manufacturer and distributor of zippers under the Talon brand name and a distributor of stretch waistbands that utilize licensed patented technology under the Tekfit brand name.

Organization and Basis of Presentation

Talon International, Inc. is the parent holding company of Tag-It, Inc., a California corporation, Tag-It Pacific (HK) Ltd., a BVI corporation, Tagit de Mexico, S.A. de C.V., Talon Technologies, Inc.(formerly A.G.S. Stationery, Inc.), a California corporation (collectively, the “Subsidiaries”), all of which were consolidated under a parent limited liability company on October 17, 1997 and became wholly-owned subsidiaries of the Company immediately prior to the effective date of the Company’s initial public offering in January 1998. Immediately prior to the initial public offering, the outstanding membership units of Tag-It Pacific, LLC were converted to 2,470,001 shares of common stock of the Company. In January 2000, the Company formed Tag-It Pacific Limited, a Hong Kong corporation, and in April 2000, the Company formed Talon International, Inc., a Delaware corporation. During 2006 the Company formed two wholly owned subsidiaries of Tag-It Pacific, Inc.; Talon Zipper (Shenzhen) Company Ltd. in China and Talon International Pvt. Ltd., in India. All newly formed corporations are 100% wholly-owned Subsidiaries of Talon International, Inc.

On July 20, 2007, the Company changed its corporate name from Tag-It Pacific, Inc. to Talon International, Inc.

All significant intercompany accounts and transactions have been eliminated in consolidation. Assets and liabilities of foreign subsidiaries are translated at rates of exchange in effect at the close of the period. Revenues and expenses are translated at the weighted average of exchange rates in effect during the year. The resulting translation gains and losses are deferred and are shown as a separate component of stockholders’ deficit, if material, and transaction gains and losses, if any, are recorded in the consolidated statement of operations in the period incurred. During 2011, 2010 and 2009, foreign currency translation and transaction gains and losses were not material. The Company does not engage in hedging activities with respect to exchange rate risk.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. The accounting estimates that require the Company’s most significant, difficult and subjective judgments include the valuation of allowance for accounts receivable and inventory, the assessment of recoverability of long-lived assets and intangible assets, stock-based compensation and the recognition and measurement of current and deferred income taxes (including the measurement of uncertain tax positions). Actual results could differ materially from the Company’s estimates.



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents. The Company had approximately \$5.4 million and \$2.6 million at financial institutions in excess of governmentally insured limits at December 31, 2011 and 2010. During 2009 the Company pledged cash of \$260,924, as compensating balance collateral in a legal dispute with a trade supplier in China. The pledged cash was included in the cash balance on December 31, 2010 and the pledge was eliminated during 2011 upon settlement of the dispute.

## Allowance for Accounts Receivable Doubtful Accounts

The Company is required to make judgments as to the collectability of accounts receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables or note receivable to their net realizable value. The Company records these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on the Company's historical experience, for issues not yet identified. The Company writes off an account when it is considered to be uncollectible. The total allowance for accounts receivable doubtful accounts at December 31, 2011 and 2010 was \$52,844 and \$133,080, respectively.

## Inventories

Inventories are stated at the lower of cost, determined using the first-in, first-out basis, or market value and are all substantially finished goods. The costs of inventory include the purchase price, inbound freight and duties, conversion costs and certain allocated production overhead costs. Inventory reserves are recorded for damaged, obsolete, excess and slow-moving inventory. The Company uses estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory.

Inventories consist of the following:

|                                   | December 31, |             |
|-----------------------------------|--------------|-------------|
|                                   | 2011         | 2010        |
| Finished goods                    | \$1,561,974  | \$2,156,026 |
| Less inventory valuation reserves | (485,452 )   | (884,035 )  |
| Total inventories                 | \$1,076,522  | \$1,271,991 |

## Impairment of Long-Lived Assets

The Company records impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of

undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy have historically caused us to reassess the carrying amount of the Company's long-lived assets.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Property and Equipment

Property and equipment are recorded at historical cost. Maintenance and repairs are expensed as incurred. Upon retirement or other disposition of property and equipment, the related cost and accumulated depreciation or amortization are removed from the accounts and any gains or losses are included in results of operations.

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

Furniture and fixtures 5 years

Machinery and equipment 5 to 10 years

Computer equipment 5 years

Leasehold improvements Term of the lease or the estimated life of the related improvements, whichever is shorter.

Dies and molds 1 year

Property and equipment consist of the following:

|   | December 31, |             |
|---|--------------|-------------|
|   | 2011         | 2010        |
| Furniture and fixtures                    | \$298,156    | \$270,998   |
| Machinery and equipment                   | 927,580      | 898,225     |
| Computer equipment                        | 3,801,393    | 3,804,988   |
| Leasehold improvements                    | 437,660      | 388,324     |
| Equipment held for sale                   | -            | 62,391      |
| Cost, total                               | 5,464,789    | 5,424,926   |
| Accumulated depreciation and amortization | 4,372,180    | 3,842,599   |
| Property and equipment, net               | \$1,092,609  | \$1,582,327 |

Depreciation expense for the years ended December 31, 2011, 2010 and 2009 was \$605,987, \$793,603 and \$725,979 respectively.

## Intangible Assets, net

Intangible assets consist of tradename and exclusive license and intellectual property rights. Intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB ASC 350, "Intangibles – Goodwill and Other". Intangible assets with estimable useful lives are amortized over their respective estimated useful lives, which average 5 years, to their estimated residual values and reviewed for impairment in accordance with FASB

ASC 360, "Property, Plant, and Equipment".

At December 31, 2011 and 2010, the Company evaluated its intangible assets and determined that there was no impairment of these assets and made no changes to the net carrying amount of tradename. No impairment and amortization expense for intangible assets was recorded for the three years ended December 31, 2011.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Intangible assets as of December 31, 2011 and 2010 are as follows:

|   | December 31, |             |
|---|--------------|-------------|
|   | 2011         | 2010        |
| Tradename   | \$4,110,751  | \$4,110,751 |
| Accumulated amortization                                | -            | -           |
| Tradename, net  | 4,110,751    | 4,110,751   |
| Exclusive license and intellectual property rights      | 612,500      | 612,500     |
| Accumulated amortization                                | (612,500 )   | (612,500 )  |
| Exclusive license and intellectual property rights, net | -            | -           |
| Intangible assets, net                                  | \$4,110,751  | \$4,110,751 |

#### Convertible Preferred Stock

The Company classifies conditionally redeemable convertible preferred shares, which includes preferred shares subject to redemption upon the occurrence of uncertain events not solely within our control, as temporary equity in the mezzanine section of the consolidated balance sheet, in accordance with the guidance enumerated in FASB ASC No. 480-10 “Distinguishing Liabilities from Equity”, FASB ASC No. 210 “Classification and Measurement of Redeemable Securities” and Rule 5-02.28 of Regulation S-X, when determining the classification and measurement of preferred stock.

The Company evaluated the conversion option of the convertible preferred shares in accordance with FASB ASC No. 470-20, “Debt with Conversion and Other Options”, Accounting for Convertible Securities with Beneficial Conversion Features (“BCF”) or Contingently Adjustable Conversion Ratios. A convertible financial instrument includes a BCF when the fair market value of the preferred stock is lower than the value of common stock when the preferred stock converts to common stock at the issuance date. The BCF shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the feature to additional paid-in capital.

Redeemable securities initially are recorded at their fair value minus the BCF and minus preferred stock issuance costs. Subsequent measurement and recognition of the changes in the preferred stock value uses the following approach:

- When an equity instrument is not currently redeemable and it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), then the changes in the redemption value (for example, fair value) are recognized immediately as they occur, and the carrying amount of the instrument is adjusted to equal the redemption value at the end of each reporting period. This method views the end of the reporting period as if it were also the redemption date for the instrument. The resulting increases in the carrying amount of the redeemable security reduce income applicable to common shareholders in the calculation of earnings per share.
- Liquidation preference increase on preferred shares is accrued against the preferred stock and reduces income applicable to common shareholders in the calculation of earnings per share.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Revenue Recognition

Sales are recognized when persuasive evidence of an arrangement exists, product delivery has occurred, pricing is fixed or determinable and collection is reasonably assured. Sales resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns and the cost of goods sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances.

Sales rebates and discounts are common practice in the industries in which the Company operates. Volume, promotional, price, cash and other discounts and customer incentives are accounted for as a reduction to gross sales. Rebates and discounts are recorded based upon estimates at the time products are sold. These estimates are based upon historical experience for similar programs and products. The Company reviews such rebates and discounts on an ongoing basis and accruals for rebates and discounts are adjusted, if necessary, as additional information becomes available.

Shipping and Handling Costs

The Company records shipping and handling costs billed to customers as a component of revenue and shipping and handling costs incurred by the Company for outbound freight are recorded as a component of cost of goods sold.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax benefit carry-forwards. Deferred tax liabilities and assets at the end of each period are determined using enacted tax rates. The Company records deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if the Company believes that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided.

The provisions of FASB ASC 740, "Income Taxes," ("ASC 740") require the establishment of a valuation allowance when, based on currently available information and other factors, it is more likely than not that all or a portion of a deferred tax asset will not be realized. ASC 740 provides that an important factor in determining whether a deferred tax asset will be realized is whether there has been sufficient income in recent years and whether sufficient income is expected in future years in order to utilize the deferred tax asset.

The Company believes that its estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On January 1, 2007 the Company adopted the provisions of accounting guidance regarding uncertain income tax positions under ASC 740. ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on the recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition associated with income tax liabilities. As a result of the implementation of ASC 740, the Company recognized an increase in liabilities for unrecognized tax benefits of approximately \$245,800, which was accounted for as an increase in the January 1, 2007 accumulated deficit. The amount has subsequently increased due to interest and penalties accrual; see Note 8.

#### Stock-Based Compensation

The Company has employee equity incentive plans, which are described more fully in Note 6. Effective January 1, 2006, the Company adopted FASB ASC 718, "Compensation - Stock Compensation" ("ASC 718"), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. Accordingly, the Company measure share-based compensation at the grant date based on the fair value of the award.

The Company adopted ASC 718 using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company's financial statements as of and for the years ended December 31, 2011, 2010 and 2009 reflect the impact of ASC 718.

ASC 718 requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statements of Operations. Stock-based compensation expense recognized in the Statements of Operations for the years ended December 31, 2011, 2010 and 2009 included compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1 of the applicable year based on the grant date fair value estimated in accordance with the pro-forma provisions of ASC 718 and compensation expense for the share-based payment awards granted subsequent to January 1 based on the grant date fair value estimated in accordance with the provisions of ASC 718. For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method. As stock-based compensation expense recognized in the Statements of Operations for 2011, 2010 and 2009 is based on awards expected to vest, ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the years ended December 31, 2011, 2010 and 2009, expected forfeitures are immaterial and as such the Company is recognizing forfeitures as they occur.

The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards and actual and projected employee stock option exercise behaviors. The Company estimates expected volatility using historical data. The expected option term is estimated using the "safe harbor" provisions under ASC 718.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Foreign Currency Translation

The Company has operations and holds assets in various foreign countries. The local currency is the functional currency for the Company's subsidiaries in China and India. Assets and liabilities are translated at end-of-period exchange rates while revenues and expenses are translated at the average exchange rates in effect during the period.

Equity is translated at historical rates and the resulting cumulative translation adjustments are included as a component of accumulated other comprehensive income (loss) until the translation adjustments are realized. Gains and losses resulting from foreign currency transactions and remeasurement adjustments of monetary assets and liabilities not held in an entity's functional currency (affects primarily the Company's subsidiary in Hong Kong where the local currency Hong Kong Dollar is not the functional currency) are included in earnings.

Classification of Expenses

Cost of Goods Sold - Cost of goods sold primarily includes expenses related to inventory purchases, customs, duty, freight, overhead expenses and reserves for obsolete inventory. Overhead expenses primarily consist of warehouse and operations salaries and other warehouse expenses.

Sales and Marketing Expense – Sales and marketing expenses primarily include royalty expense, sales salaries and commissions, travel and entertainment, marketing and other sales-related costs.

General and Administrative Expenses - General and administrative expenses primarily include administrative salaries, employee benefits, professional service fees, facility expenses, information technology costs, investor relations, travel and entertainment, depreciation and amortization, bad debts, restructuring costs and other general corporate expenses.

Interest Expense and Interest Income – Interest expense reflects the cost of borrowing and amortization of deferred financing costs and discounts. Interest expense for the years ended December 31, 2011, 2010 and 2009 was \$128,188, \$1,802,503 and \$2,735,437, respectively. Interest income of \$4,190, \$30,841 and \$7,518 for the years ended December 31, 2011, 2010 and 2009, respectively, consists of earnings from outstanding amounts due to the Company under notes and other interest bearing receivables.

Comprehensive Income

The Company has adopted FASB ASC 220, "Comprehensive Income" ("ASC 220"), issued by the FASB and effective for financial statements with fiscal years beginning after December 15, 1997. ASC 220 establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements.

Included in comprehensive income (loss) for the years ended December 31, 2011, 2010 and 2009 are unrealized gains (losses) in foreign currency translation of \$31,474 and \$(43,534) and \$(25,448), respectively. The foreign currency translation adjustment represents the net currency translation adjustment gains and losses related to the Company's China and India subsidiaries.

Reclassification

Certain reclassifications have been made to the prior year financial statements to conform to 2011 presentation.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Litigation

The Company is involved in various lawsuits, claims and inquiries, most of which are routine to the nature of the business and in accordance with FASB ASC 450, "Contingencies", the Company accrue estimates of the probable and estimable losses for the resolution of these claims. The ultimate resolution of these claims could affect the Company's future results of operations for any particular quarterly or annual period should the Company's exposure be materially different from the Company's earlier estimates or should liabilities be incurred that were not previously accrued. See Note 9.

Fair Value of Financial Instruments

Effective January 1, 2008, the Company adopted Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") No. 820, "Fair Value Measurements and Disclosures" ("ASC 820"). Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the guidance establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1—Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2—Include other inputs that are directly or indirectly observable in the marketplace.

Level 3—Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

In accordance with this guidance, the Company measures its cash equivalents at fair value. The Company's cash equivalents are classified within Level 1. Cash equivalents are valued primarily using quoted market prices utilizing market observable inputs. At December 31, 2011 and 2010, cash equivalents consisted of money market fund balances measured at fair value on a recurring basis; fair value of the Company's money market funds was approximately \$1,822,000 and \$1,506,000, respectively.

New Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update ("ASU") 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" ("ASU 2011-04") which amends ASC Topic 820, Fair Value Measurement. ASU 2011-04 changes the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The update clarifies the application of existing fair value measurement requirements. The update also requires reporting entities to disclose additional information regarding fair value measurements categorized within Level 3 of the fair value hierarchy. ASU 2011-04 is effective during interim and annual period beginning after December 15, 2011. Early adoption is not permitted. The adoption of this guidance will not have any impact on the Company's results of operations and financial condition.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income" ("ASU 2011-05") which amends ASC Topic 220, Comprehensive Income. ASU 2011-05 gives an entity the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance in ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not have any impact on the Company's results of operations or financial condition.

In September 2011, the FASB issued ASU 2011-08, "Intangibles – Goodwill and Other (Topic 350) — Testing Goodwill for Impairment". This amendment allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative impairment test. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 and early adoption is permitted. The Company does not expect this amendment to have an impact on its financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220)". The amendments in this Update supersede certain pending paragraphs in ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, to effectively defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments will be temporary to allow the Board time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. ASU 2011-12 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not have any impact on our results of operations or financial condition.

NOTE 2 — NOTES PAYABLE TO RELATED PARTIES

Demand notes payable to related parties as of December 31, 2010 included two notes payable issued from 1995-1998 to parties related to or affiliated with Mark Dyne, the Chairman of the Board of Directors of the Company and a significant stockholder with interest rates of 10% per annum, due and payable on the fifteenth day following delivery of written demand for payment. On August 2, 2011 the Promissory Note dated as of June 30, 1991 in favor of Harold Dyne was paid in full, including accrued interest, for \$44,340. Subsequent to the year ending December 31, 2011 the note in favor of Monto Holdings Pty, Ltd was paid in full, including accrued interest, for \$199,798.

On August 6, 2009 a note was issued to Lonnie D. Schnell, the Chief Executive Officer and Chief Financial Officer of the Company in partial satisfaction of 2008 annual incentive awards to which Mr. Schnell was entitled. The note bears 6% interest annually and the maturity date was the earlier of December 31, 2011 or ten days following Mr. Schnell's employment termination date. The note is fully presented in current liabilities. Interest on the note began accruing as of April 16, 2009 the date the award was originally required to be paid. The note was paid in full subsequent to the year ending December 31, 2011.

The outstanding amounts of notes payable to related parties in current liabilities as of December 31, 2011 and 2010 were \$239,942 and \$275,215, respectively.



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Interest expense, interest accrual and interest amount paid related to the notes payable to related parties for the years ended December 31, 2011, 2010 and 2009 are as follows:

|                          | Year Ended December 31, |           |           |
|--------------------------|-------------------------|-----------|-----------|
|                          | 2011                    | 2010      | 2009      |
| Interest expense         | \$9,066                 | \$9,344   | \$8,608   |
| Accrued interest balance | \$144,023               | \$155,040 | \$145,696 |
| Interest paid            | \$20,083                | \$-       | \$-       |

## NOTE 3—LONG TERM OBLIGATIONS

## Capital Leases

The Company financed equipment purchases through various capital lease obligations expiring through June 2014. These obligations bear interest at various rates ranging from 8.0% to 15.4% per annum. Future minimum annual payments under these capital lease obligations are as follows:

| Years ending December 31,         | Amount   |
|-----------------------------------|----------|
| 2012                              | \$9,236  |
| 2013                              | 8,894    |
| 2014                              | 2,572    |
| Total payments                    | 20,702   |
| Less amount representing interest | (3,243 ) |
| Balance at December 31, 2011      | 17,459   |
| Less current portion              | 6,998    |
| Long-term portion                 | \$10,461 |

At December 31, 2011, total property and equipment under capital lease obligations and related accumulated depreciation was \$31,450 and \$16,532, respectively. At December 31, 2010, total property and equipment under capital lease obligations and related accumulated depreciation was \$31,450 and \$10,206, respectively.

## Note Payable

Note payable consists of the following:

| December 31, |      |
|--------------|------|
| 2011         | 2010 |
|              |      |

\$25,200 demand note payable to E.C.D. International dated September 30, 1995; interest at 10.0%; payable on the fifteenth day following delivery of written demand for payment; balance includes accrued interest of \$40,950

|  |          |          |
|--|----------|----------|
|  | \$66,150 | \$63,630 |
|--|----------|----------|

The note was paid in full subsequent to the year ending December 31, 2011.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - DEBT FACILITY

On July 30, 2010, the Company entered into a Recapitalization Agreement (the "Recapitalization Agreement") with CVC California, LLC ("CVC") in which the Company issued to CVC shares of the Company's Series B Convertible Preferred Stock in payment of all of the outstanding obligations owed by the Company to CVC under the Revolving Credit and Term Loan Agreement (the "Loan Agreement", see Note 5) originally entered into by the Company on June 27, 2007 with Bluefin Capital, LLC ("Bluefin"). Bluefin subsequently assigned its rights and obligations under the Loan Agreement to an affiliate, CVC. At July 30, 2010, all of the outstanding obligations owed to CVC under the Loan Agreement became due and payable, consisting of outstanding borrowings and accrued interest of \$11,548,098 under the term notes, and \$5,158,587 under the revolving credit note, for a total of \$16,706,685. All of these outstanding obligations were converted into Series B Convertible Preferred Stock on July 30, 2010.

The Company originally entered into the Loan Agreement on June 27, 2007, which had provided for initial borrowings of \$4.3 million under a revolving credit loan and a \$9.5 million term loan for a three year period ending June 30, 2010. In connection with the initial Loan Agreement, the Company issued to Bluefin 1,500,000 shares of common stock for \$0.001 per share and issued warrants for the purchase of 2,100,000 common shares at prices ranging from \$1.05 per share to \$1.14 per share.

On November 19, 2007, the Company amended the Loan Agreement to modify the original financial covenants in exchange for the issuance of an additional 250,000 shares of common stock to the lender for \$0.001 per share, and a lowering of the exercise price for all of the previously issued warrants to an exercise price of \$0.75 per share.

On April 3, 2008, the Company further amended the Loan Agreement to redefine the EBITDA covenants, and to cancel all of the common stock warrants previously issued to the lender in exchange for a note payable for \$1.0 million issued by the Company under the same terms as the original Loan Agreement. In connection with this amendment the Company evaluated the Loan Agreement amendment under ASC 470-50, "Debt - Modifications and Extinguishments". It was determined that the amendment did not constitute a material change as defined by ASC 470-50. Accordingly, the Company recorded a reduction to equity and an increase to notes payable for the fair value of the warrants of \$260,205 and the difference (\$739,795) between the fair value of the warrants at the time of repurchase and the face value of the note was recorded as an additional deferred cost and was reflected as a reduction to the face value of the note on the balance sheet. This cost was amortized using the interest-method over the life of the modified notes and was reflected as interest expense. At June 30, 2010 the modification cost was fully amortized.

Under the terms of the amended Loan Agreement, the Company was required to meet certain coverage ratios, among other restrictions, including a restriction from declaring or paying a dividend prior to repayment of all the obligations. The amended financial covenants require that the Company maintain at the end of each fiscal quarter "EBITDA" (as defined in the agreement) of not less than \$1.00 for the period and in excess of the ratios set out in the agreement for each quarter.

The Company failed to satisfy the minimum EBITDA requirement for the two quarters ended December 31, 2008 and March 31, 2009, and in connection with such failures, on March 31, 2009 the Company further amended the Loan Agreement to provided for, among other things, the issuance of an additional term note to CVC in the principal amount of \$225,210 in lieu of paying a cash waiver fee.

On June 30, 2010 the Loan Agreement was amended to extend the existing maturity date for an additional thirty days to July 30, 2010. The Loan Agreement (as amended) was scheduled to mature July 30, 2010 and all of the principal and interest arising under the Loan Agreement in the approximate amount of \$16.7 million was due at maturity. The Company did not have sufficient resources to pay this obligation on the maturity date and consequently entered into the Recapitalization Agreement.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In connection with the Recapitalization Agreement, the Loan Agreement (now fully paid) was amended to extend the maturity date from July 30, 2010 until July 31, 2012, reduce the maximum borrowings available under the Revolver to \$3,000,000, amend the borrowing base to modify the advance rate applicable to eligible accounts receivable to 75% and modify the advance rate applicable to eligible inventory to 40%, eliminate loan maintenance fees, and modify the permissible amount of capital expenditures the Company can make in any fiscal year. The Company paid CVC a non-refundable fee in the amount of \$60,000 in consideration of CVC entering into the amendment and making this facility available and paid a \$50,000 commitment fee during the third quarter of 2011 to ensure the availability of the revolver through July 31, 2012. Upon execution of the amendment, CVC waived all prior events of default under the Loan Agreement. Borrowings under the Loan Agreement are secured by all of the Company's assets.

At December 31, 2011 and 2010, there were no borrowings under the revolving credit facility portion of the Loan Agreement, no term loans under the Loan Agreement and the Company was in compliance with all loan covenants.

Interest expense related to the Loan Agreement is composed of interest on debt, amortization of debt discount, and amortization of deferred financing costs. In total, the interest expense for the years ended December 31, 2011, 2010 and 2009 was \$50,833, \$1,754,453 and \$2,638,927, respectively. Total interest expense in the periods was comprised as follows:

- Interest on debt related to the Loan Agreement for the years ended December 31, 2011, 2010 and 2009 was \$0, \$892,857 and \$1,176,364, respectively.
- Amortization of the debt discount related to the Loan Agreement for the years ended December 31, 2011, 2010 and 2009 was \$0, \$725,982 and \$1,228,047, respectively.
- Amortization of deferred financing costs related to the Loan Agreement for the years ended December 31, 2011, 2010 and 2009 was \$30,000 \$135,614 and \$234,516, respectively.
- Commitment fee expense for the year ended December 31, 2011 was \$20,833.

NOTE 5—PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)

Preferred Stock

Series B Convertible Preferred Stock

On July 30, 2010, the Company entered into the Recapitalization Agreement with CVC, pursuant to which the Company issued to CVC an aggregate of 407,160 shares of a newly created series of the Company's preferred stock, designated Series B Convertible Preferred Stock, \$0.001 par value per share (the "Series B Preferred Stock"), in payment of an aggregate of \$16,706,685 owed by the Company to CVC under the Loan Agreement. Certain rights, preferences, privileges and restrictions of the Series B Preferred Stock are summarized below.

On July 30, 2010, the Company amended its certificate of incorporation by creating the Series B Preferred Stock with the following rights, preferences, privileges and restrictions:

-

The Series B Preferred Stock ranks senior to the common stock and to any other preferred stock unless such preferred stock is created and issued on a senior or pari passu basis in accordance with the Company's certificate of incorporation.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- Each share of Series B Preferred Stock is convertible into 100 shares of the Company's common stock (subject to adjustment for stock splits, reverse stock split, etc.) at any time and from time to time at each holder's option, unless the Series B Preferred Stock is exchanged for its Liquidation Preference as noted below.
- Upon the liquidation, dissolution or winding up of the Company, each share of Series B Preferred Stock is entitled to receive upon the surrender and cancellation of such shares (and prior to any distribution to holders of other equity securities), an amount equal to \$41.033 per share plus all accrued dividends (the "Liquidation Preference"). A merger, consolidation, share exchange or other reorganization resulting in a change in control of the Company, or any sale of all or substantially all of the Company's assets, will be deemed a liquidation and winding up for purposes of the Company's obligation to pay the Liquidation Preference.
- The Series B Preferred Stock Liquidation Preference will increase with the accrual of dividends on the Liquidation Preference at the rate of 16% per annum, compounded annually. The dividends however are only payable to the holder in connection with the payment of the Liquidation Preference upon the liquidation, dissolution or winding up of the Company and in conjunction with the surrender of the Preferred Stock. No portion of the Liquidation Preference or the associated accrued dividends are convertible into common stock, nor will any portion of the Liquidation Preference or the accrued dividends be payable on shares of Series B Preferred Stock in the event of or following the conversion of such shares into common stock.
- The Company has the right, at any time upon not less than thirty (30) days' prior written notice to the holders of Series B Preferred Stock, to redeem the Series B Preferred Stock in whole (but not in part) for a price equal to the then-applicable Liquidation Preference. The holders of Series B Preferred Stock shall have the option, exercisable at any time and from time to time commencing on July 31, 2016, to require the Company to redeem any or all of the Series B Preferred Stock held by such holders, at the then-applicable Liquidation Preference amount. The Series B Preferred Stock vote with the common stock as a single class on all matters submitted or required to be submitted to a vote of the Company's stockholders, with each share of Series B Preferred Stock having a number of votes equal to the number of shares of common stock that may be acquired upon conversion thereof as of the applicable date of determination. Additionally, the Series B Preferred Stock have the right to vote as a separate class with respect to certain matters affecting the Series B Preferred Stock, including but not limited to (i) the creation or issuance of any other class or series of preferred stock, (ii) any amendments with respect to the rights, powers, preferences and limitations of the Series B Preferred Stock, (iii) paying dividends or distributions in respect of or redeem the Company's common stock or any other junior securities; and (iv) certain affiliate transactions. Any such vote shall require the affirmative vote or consent of a majority of the outstanding shares of Series B Preferred Stock.
- As long as the outstanding Series B Preferred Stock represents 35% or more of the voting shares of the Company, on an as-converted to common stock basis, then (a) our Board of Directors shall consist of not more than seven members, (b) the holders of Series B Preferred Stock shall have the right to elect three directors if the Board has five or fewer total directors, and four directors if the Board has six or seven directors (the directors elected by the Series B Preferred Stock are referred to as the "Series B Directors"), and (c) those members serving on the Board who were not elected by holders of the Series B Preferred Stock shall have the right to designate all remaining directors. At least two of the Series B Directors must be, and remain at all times while serving as a director, an independent director that qualifies for service on the audit committee of a corporation with securities listed on the Nasdaq Stock Market as provided in Nasdaq Marketplace Rule 5605(c)(2) (or any successor thereto). Once the outstanding shares of Series B Preferred Stock represent less than 35% of the voting shares on an as-converted to common stock basis, then the entire Board will thereafter be elected by all stockholders having voting rights, voting

as a single class.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The conversion of the term notes, revolver and related interest and fees into the Series B Preferred Stock (fair value of \$17,277,600 as of July 30, 2010) was considered to be debt extinguishment according to the FASB ASC No.405 “Liabilities” and FASB ASC No. 470-50 “Debt, Modifications and Extinguishments” (“ASC 470-50”). Per ASC 470-50 a loss on extinguishment of debt of \$570,915 was recorded on July 30, 2010 and is included in the Consolidated Statement of Operations for the year ended December 31, 2010. The loss on extinguishment is equal to the difference between fair value of the preferred stock and the fair value of the debt extinguished at the transaction date. The fair value of the Series B Preferred Stock on the issuance date was determined by the Company and independent valuation specialists using the option pricing valuation model.

The Company applied the guidance enumerated in FASB ASC No. 480 “Distinguishing Liabilities from Equity”, FASB ASC No. 210 “Classification and Measurement of Redeemable Securities” and Rule 5-02.28 of Regulation S-X, when determining the classification and measurement of preferred stock. The Company classifies conditionally redeemable convertible preferred shares, which includes preferred shares subject to redemption upon the occurrence of uncertain events not solely within the control of the Company, as temporary equity in the mezzanine section of the consolidated balance sheet. The Series B Preferred Stock is redeemable at the option of the holders after the sixth anniversary of issuance, which is not within the control of the Company.

The Company determined that there are no embedded features that would require separate reporting as derivative instruments. Therefore, the Company evaluated the conversion option of the convertible preferred shares under FASB ASC No. 470-20, “Debt with Conversion and Other Options”, Accounting for Convertible Securities with Beneficial Conversion Features (“BCF”) or Contingently Adjustable Conversion Ratios. A convertible financial instrument includes a BCF if the fair value of the instrument is lower than the fair value of shares of the common stock it is convertible into on the issuance date. The BCF shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the conversion feature to additional paid-in capital. The Company has recorded a BCF value of \$1,283,343 in connection with the issuance of the Series B Preferred Stock on July 30, 2010.

The Series B Preferred Stock was initially recorded at the fair value of \$17,277,600 as of July 30, 2010, reduced by the BCF (\$1,283,343) as stated above and stock issuance costs (\$190,744), for a net value of \$15,803,513 as of July 30, 2010. The value of the Series B Preferred Stock was adjusted as follows as a consequence of its redemption features and the following approach is implemented by the Company:

- The Series B Preferred Stock is not currently redeemable but it is probable that the preferred stock will become redeemable due to the redemption option available to the preferred stock holders on July 30, 2016. Changes in the redemption value (for example, fair value) are recognized immediately as they occur, and the carrying amount of the instrument is adjusted to equal the redemption value at the end of each reporting period.

This method views the end of the reporting period as if it were also the redemption date for the Series B Preferred Stock. Accordingly, the adjustment of \$903,172 to record the preferred stock at its redemption value (“Original issue discount”) was charged against the preferred stock carrying value and retained earnings during the year ended December 31, 2010. In addition, the resulting increase in the carrying amount of the Series B Preferred Stock reduces the income applicable to common shareholders reported in the calculation of earnings per share.

- The 16% liquidation preference increase (compounded annually) on outstanding preferred shares is accrued each reporting period as an addition to the carrying value of the preferred stock and reduces the income applicable to common shareholders reported in the calculation of earnings per share.



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes Series B Preferred Stock activity:

|   |              |
|---|--------------|
| Series B Preferred Stock as of December 31, 2008 and 2009                             | \$-          |
| Series B Preferred Stock, net of discount for BCF and issuance costs on July 30, 2010 | 15,803,513   |
| Series B Preferred Stock original issue discount                                      | 903,172      |
| Series B Preferred Stock liquidation preference increase                              | 1,113,779    |
| Series B Preferred Stock as of December 31, 2010                                      | 17,820,464   |
| Series B Preferred Stock liquidation preference increase                              | 2,851,274    |
| Series B Preferred Stock as of December 31, 2011                                      | \$20,671,738 |

## Series A Preferred Stock

In October 1998, the Company adopted a stockholder's rights plan. Under the rights plan the Company distributed one preferred share purchase right for each outstanding share of Common Stock outstanding on November 6, 1998. Upon the occurrence of certain triggering events related to an unsolicited takeover attempt of the Company, each purchase right not owned by the party or parties making the unsolicited takeover attempt will entitle its holder to purchase shares of the Company's Series A Preferred Stock at a value below the then market value of the Series A Preferred Stock. The rights of holders of the Common Stock will be subject to, and may be adversely affected by, the rights of holders of the share purchase rights, the Series A Preferred Stock and any other preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes could make it more difficult for a third party to acquire a majority of the Company's outstanding voting stock.

## Common Stock

## Stockholders Agreement

Concurrently with execution of the Recapitalization Agreement, on July 30, 2010, the Company entered into a Stockholders Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors of the Company, and Larry Dyne, President of the Company ("Messrs. Schnell and Dyne"), pursuant to which:

- CVC agreed that in connection with any director nominees to be submitted to holders of the Company's common stock for election at a stockholders' meeting, a committee of our Board comprised solely of directors then serving on the Board who were not elected or appointed by holders of Series B Preferred Stock, acting by majority vote, shall have the right to designate all of the Board's nominees for director to be elected by holders of the Company's Common Stock.
- CVC agreed that in connection with any election of directors submitted to the Company's stockholders for election at a stockholders' meeting, CVC will attend the stockholders' meeting, in person or by proxy, and vote (or cause to be voted) all of CVC's shares of the Company's voting stock in favor of the Board's nominees for director.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- Messrs. Schnell and Dyne provided CVC with a right of first refusal with respect to any shares of the Company's voting securities that Messrs. Schnell and Dyne propose to sell in a private placement transaction, and agreed to provide CVC with advance notice of their intent to sell the Company's voting securities in any public sale transaction.
- CVC provided Messrs. Schnell and Dyne with a tag-along right, providing Messrs. Schnell and Dyne with the right to sell their shares of the Company's voting securities in a transaction where CVC is selling its shares of the Company's voting securities.
  - Messrs. Schnell and Dyne agreed with CVC to vote their shares of Talon voting stock in favor of a Triggering Transaction, in each case to the extent such transaction is first approved by CVC.
- CVC agreed not to sell or otherwise transfer its shares of the Company's voting securities, or to vote its shares of the Company's voting securities in favor of any Triggering Transaction, at any time on or before July 31, 2011, other than in connection with a transaction that is approved by a majority of the Company's voting shares (where, in calculating such majority, the votes attributable to CVC's shares of the Company's voting securities are excluded in the numerator but included in the denominator).
- The Company provided CVC with a preemptive right, pursuant to which CVC will have the right, subject to certain exceptions set forth in the Stockholders Agreement, to acquire in a subsequent issuance of securities by the Company a number of offered securities that will allow CVC to maintain its percentage ownership of the Company's voting securities.
- CVC agreed with Messrs. Schnell and Dyne that in connection with a Triggering Transaction, CVC, and any other holder of Series B Preferred Stock and shares of common stock acquired upon conversion thereof, shall pay to Messrs. Schnell and Dyne a portion (beginning at 5% and increasing to 10%) of the sales proceeds payable in the Triggering Transaction to CVC or such other holder in respect of such Series B Preferred Stock or conversion shares. Each of Messrs. Schnell and Dyne's right to receive such portion of the sales proceeds is conditional upon the Triggering Transaction occurring (i) while employed by the Company or (ii) within 12 months following termination of employment with the Company for any reason other than termination of employment for "cause" or termination of employment by Messrs. Schnell or Dyne without "good reason" (as such terms are defined in their respective employment agreements).

#### Change in Board of Directors

In connection with the Recapitalization Agreement, on July 30, 2010, the Board of Directors was reconfigured to consist of five members, with three members designated by the Series B Preferred Stockholders to serve as Series B Directors.

In 2010 the Company obtained stockholder approval of an amendment to the certificate of incorporation to eliminate the provisions thereof requiring a classified Board of Directors.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Exclusive License and Intellectual Property Rights Agreement

On April 2, 2002, the Company entered into an Exclusive License and Intellectual Property Rights Agreement (the "Agreement") with Pro-Fit Holdings Limited ("Pro-Fit"). The Agreement gives the Company the exclusive rights to sell or sublicense waistbands manufactured under patented technology developed by Pro-Fit for garments manufactured anywhere in the world for the United States market and all United States brands. In accordance with the Agreement, the Company issued 150,000 shares of its common stock which were recorded at the market value of the stock on the date of the Agreement. The Agreement has an indefinite term that extends for the duration of the trade secrets licensed under the Agreement. The Company has recorded an intangible asset amounting to \$612,500, which is fully amortized. Subsequent to the year ending December 31, 2011 the Agreement was terminated, and the Company acquired all of the U.S. patents, license, rights and technology associated with the former exclusive license.

NOTE 6—STOCK-BASED COMPENSATION

The Company accounts for stock-based awards to employees and directors in accordance with FASB ASC 718, "Compensation - Stock Compensation" ("ASC 718"), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values.

Stock Options

On July 14, 2008, at the Company's annual meeting of stockholders, the 2008 Stock Plan was approved by the stockholders. The 2008 Stock Plan authorized up to 2,500,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. On November 19, 2010, the Company's stockholders approved an amendment to the Company's 2008 Stock Incentive Plan to increase from 2,500,000 to 4,810,000 the number of shares of common stock that may be issued pursuant to awards thereunder.

On July 31, 2007, at the Company's annual meeting of stockholders, the 2007 Stock Plan was approved which replaced the 1997 Stock Plan. The 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan.

On October 1, 1997, the Company adopted the 1997 Stock Incentive Plan (the "1997 Plan"), which authorized the granting of a variety of stock-based incentive awards. The Board of Directors, who determines the recipients and terms of the awards granted, administers the 1997 Plan. On July 31, 2006 at the Company's annual meeting of stockholder's two amendments to the 1997 Stock Plan were approved which (1) increased the maximum number of shares of common stock that may be issued pursuant to awards granted under the 1997 Plan from 3,077,500 shares to 6,000,000 shares and (2) increased the number of shares of common stock that may be issued pursuant to awards granted to any individual under the plan in a single year to 50% of the total number of shares available under the plan. The Company believed that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Company's stock on the date of the grant for years prior to 2006, and for the years ending after 2006, the average market price of the Company's stock for the five trading days following the date of approval of the grant. Those option awards generally vest over periods determined by the Board from immediate to 4 years of continuous service and have 10 year contractual terms.

Options granted for the year ended December 31, 2011, 2010 and 2009 totaled 1,405,000, 530,000 and 1,955,000, respectively.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Options granted to certain employees in 2008 included certain vesting acceleration features based on Company performance as determined by the Board of Directors each year. Consistent with ASC 718-10, the stock based compensation expense for the employee options are recognized on a time-phased vesting schedule through the vesting date of December 31, 2010. In calculating the outcome of meeting performance conditions for 2009, the Company exceeded the performance criteria and accordingly, accelerated vesting was applied to the eligible stock options.

During the year ended December 31, 2011, a former employee exercised options to acquire 109,375 shares of common stock under the 2008 Stock Incentive Plan. Cash received upon exercise was \$12,030 or \$0.11 per share. At the time of exercise, the intrinsic value of the options exercised was \$0.04 per share. No options were exercised during the years ended December 31, 2010 and 2009.

The transactions completed in association with the Recapitalization Agreement constituted a change of control of the Company and as a result, on July 30, 2010, all options previously granted to Messrs. Schnell and Dyne became fully vested in accordance with provisions in their employment agreements. On July 30, 2010 the Company entered into an executive employment agreement with each of Messrs. Schnell and Dyne, and terminated their existing employment agreements, both dated June 18, 2008. As part of these transactions, each of Messrs. Schnell and Dyne agreed to cancel all options to purchase shares of the Company's common stock previously awarded to them on or before December 31, 2007, and these options totaling 1,005,500 were cancelled effective July 30, 2010 (See Note 5).

The following table summarizes all options issued to employees and directors including those issued outside the plan.

| Employees and Directors                 | Number of<br>Shares | Weighted<br>Average<br>Exercise Price |
|---|---------------------|---------------------------------------|
| Options outstanding - December 31, 2008 | 7,100,536           | \$0.98                                |
| Granted                                 | 1,955,000           | \$0.09                                |
| Exercised                               | (2,417,686 )        | \$0.96                                |
| Options outstanding - December 31, 2009 | 6,637,850           | \$0.73                                |
| Granted                                 | 530,000             | \$0.16                                |
| Cancelled                               | (2,020,750 )        | \$1.56                                |
| Options outstanding - December 31, 2010 | 5,147,100           | \$0.35                                |
| Granted                                 | 1,405,000           | \$0.10                                |
| Exercised                               | (109,375 )          | \$0.11                                |
| Cancelled                               | (300,625 )          | \$1.79                                |
| Options outstanding - December 31, 2011 | 6,142,100           | \$0.22                                |

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company's determination of fair value of share-based payment awards on the date of grant uses the Black-Scholes model and the assumptions noted in the following table for the years ended December 31. Expected volatilities are based on the historical volatility of the Company's stock price and other factors. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards and actual and projected employee stock option exercise behaviors. The expected option term is estimated using the "safe harbor" provisions under ASC 718. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield in effect at the time of the grant.

|                        | Year ended December 31, |     |      |     |         |     |
|------------------------|-------------------------|-----|------|-----|---------|-----|
|                        | 2011                    |     | 2010 |     | 2009    |     |
| Expected volatility    | 134-138                 | %   | 131  | %   | 115-122 | %   |
| Expected term in years | 5.3-6.1                 | yrs | 6.1  | yrs | 5.0-6.1 | yrs |
| Expected dividends     | -                       |     | -    |     | -       |     |
| Risk-free rate         | 1.5-2.7                 | %   | 1.9  | %   | 2.7-3.3 | %   |

A summary of the Company's stock option information under all Stock Plans as of December 31, 2011 is as follows:

|                                  | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Intrinsic<br>Value |
|----------------------------------|------------------------|--|--|--------------------|
| Employees and Directors          |                        |  |  |                    |
| Outstanding at December 31, 2011 | 6,142,100              | \$0.22                                   | 7.5  | \$0.02             |
| Vested and Expected to Vest      | 6,080,531              | \$0.23                                   | 7.7  | \$0.02             |
| Exercisable                      | 4,633,378              | \$0.26                                   | 7.0  | \$0.02             |

The aggregate intrinsic value of the stock options is calculated as the difference between the exercise price of a stock option and the quoted price of the Company's common stock at December 31, 2011. It excludes stock options that have exercise prices in excess of the quoted price of the Company's common stock at December 31, 2011.

There was approximately \$135,000 of total unrecognized compensation costs related to non-vested stock options as of December 31, 2011. This cost is expected to be recognized over the weighted-average period of 2.7 years.

When options are exercised, the Company's policy is to issue previously registered, unissued shares of common stock. In July of 2008 and 2007, at the Company's annual meetings of stockholders, the 2008 and 2007 Stock Plans were approved, which authorize up to 2,500,000 and 2,600,000 shares of common stock, respectively, for issuance pursuant to awards granted to individuals under the plan.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Restricted Stock Units (RSU's)

On July 30, 2010, the Company awarded each of Messrs. Schnell and Dyne a restricted stock unit award (an "RSU Award") for 5,778,500 shares of the Company's common stock. Each RSU Award vested 50% on August 30, 2011, and vests 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to partial acceleration of vesting as part of the executives' severance benefits and full acceleration of vesting upon a change in control of the Company. As of July 30, 2010, the RSU's were valued at \$2,263,384 which was reduced by the fair value of the options surrendered (see Stock Options above).

On August 30, 2010, Messrs. Schnell and Dyne elected to defer the settlement in common shares of 5,178,500 RSU's beyond the vesting dates. On August 30, 2011, based on the deferral schedules, 600,000 common shares were issued upon settlement of a portion of vested units under the RSU Awards. At the time of the issuance of shares the intrinsic value of these RSU's was \$0.10 per share.

As of December 31, 2011, the Company had \$949,943 of unamortized stock-based compensation expense related to RSU's, which will be recognized over the remaining weighted average period of 1.3 years. As of December 31, 2010, the Company had \$1,823,684 of unamortized stock-based compensation expense related to RSU's, which was to be recognized over the remaining weighted average period of 1.5 years.

The following table summarizes RSU's activity:

|  | Unvested     | Number of RSU's<br>Vested | Total      | Weighted<br>Average<br>Grant<br>date<br>value<br>per<br>RSU |
|--|--------------|---------------------------|------------|---|
| RSU's outstanding -<br>December 31, 2008 and<br>2009 | -            | -                         | -          | \$ -  |
| RSU's Issued   | 11,557,000   | -                         | 11,557,000 | \$ 0.196  |
| RSU's outstanding -<br>December 31, 2010             | 11,557,000   | -                         | 11,557,000 | \$ 0.196  |
| Vested   | (5,778,500 ) | 5,778,500                 | -          | \$ 0.196  |
| Common stock issued                                  | -            | (600,000 )                | (600,000 ) | \$ 0.196  |
| RSU's outstanding -<br>December 31, 2011             | 5,778,500    | 5,178,500                 | 10,957,000 | \$ 0.196  |

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 7—NET LOSS PER SHARE

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

| Years ended:  | Net income<br>(loss)<br>(Numerator) | 2011                    |                        | Year Ended December 31,<br>2010 |                         |                        | 2009                    |                         | Per<br>Share<br>Amount |
|---|-------------------------------------|-------------------------|------------------------|---------------------------------|-------------------------|------------------------|-------------------------|-------------------------|------------------------|
|   |                                     | Shares<br>(Denominator) | Per<br>Share<br>Amount | Net loss<br>(Numerator)         | Shares<br>(Denominator) | Per<br>Share<br>Amount | Net loss<br>(Numerator) | Shares<br>(Denominator) |                        |
| Net income<br>(loss)  | \$729,133                           | 20,567,640              | \$0.04                 | \$(1,466,820)                   | 20,291,433              | \$(0.07)               | \$(2,692,977)           | 20,291,433              | \$(0.13)               |
| Series B<br>preferred<br>stock<br>original<br>discount                      | -                                   | -                       | -                      | (903,172 )                      | -                       | (0.04)                 | -                       | -                       | -                      |
| Series B<br>Preferred<br>stock<br>liquidation<br>preference<br>increase     | (2,851,274)                         | -                       | (0.14)                 | (1,113,779)                     | -                       | (0.06)                 | -                       | -                       | -                      |
| Basic and<br>diluted net<br>loss<br>applicable to<br>common<br>stockholders | \$(2,122,141)                       | 20,567,640              | \$(0.10)               | \$(3,483,771)                   | 20,291,433              | \$(0.17)               | \$(2,692,977)           | 20,291,433              | \$(0.13)               |

Options to purchase 6,142,100 shares of common stock for between \$0.06 and \$5.23, per share were outstanding for the year ended December 31, 2011, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share.

Options to purchase 5,147,100 shares of common stock for between \$0.06 and \$5.23, per share were outstanding for the year ended December 31, 2010, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share.

Options to purchase 6,637,850 shares of common stock for between \$0.06 and \$5.23, per share were outstanding for the year ended December 31, 2009, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share.



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 8—INCOME TAXES

The components of the provision for income taxes included in the consolidated statements of operations are as follows:

|           | Year Ended December 31, |           |           |
|-----------|-------------------------|-----------|-----------|
|           | 2011                    | 2010      | 2009      |
| Current:  |                         |           |           |
| Federal   | \$161,306               | \$12,588  | \$-       |
| State     | 2,528                   | 978       | (1,109 )  |
| Foreign   | 84,560                  | (4,579 )  | 126,517   |
|           | 248,394                 | 8,987     | 125,408   |
| Deferred: |                         |           |           |
| Federal   | 115,800                 | 479,353   | -         |
| State     | 26,794                  | 129,201   | -         |
| Foreign   | 95,129                  | (21,890 ) | 128,726   |
|           | 237,723                 | 586,664   | 128,726   |
|           | \$486,117               | \$595,651 | \$254,134 |

A reconciliation of the statutory Federal income tax rate with the Company's effective income tax rate is as follows:

|  | Year Ended December 31, |   |         |   |         |   |
|--|-------------------------|---|---------|---|---------|---|
|  | 2011                    |   | 2010    |   | 2009    |   |
| Current:                               |                         |   |         |   |         |   |
| Federal statutory rate                 | 34.0                    | % | 34.0    | % | 34.0    | % |
| State taxes net of federal benefit     | 1.6                     |   | (9.9 )  |   | 0.0     |   |
| Change in effective foreign tax rate   | (26.0 )                 |   | (3.2 )  |   | (0.6 )  |   |
| Loss on extinguishment of debt         | -                       |   | (22.3 ) |   | -       |   |
| Other permanent differences            | (13.6 )                 |   | (6.5 )  |   | (1.8 )  |   |
| Foreign withholding taxes              | 24.7                    |   | (5.2 )  |   | (3.3 )  |   |
| Net operating loss valuation allowance | 35.9                    |   | (1.3 )  |   | (23.2 ) |   |
| Other                                  | (16.6 )                 |   | (54.0 ) |   | (15.5 ) |   |
|  | 40.0                    | % | (68.4 ) | % | (10.4 ) | % |

Net income (loss) before income taxes is as follows:

|          | Year Ended December 31, |              |                |
|----------|-------------------------|--------------|----------------|
|          | 2011                    | 2010         | 2009           |
| Domestic | \$(457,736 )            | \$(670,201 ) | \$(2,180,959 ) |
| Foreign  | 1,672,986               | (200,968 )   | (257,884 )     |
|          | \$1,215,250             | \$(871,169 ) | \$(2,438,843 ) |



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The primary components of temporary differences which give rise to the Company's deferred tax being presented as part of Other assets or Deferred income taxes (in long term liabilities) in the Company's balance sheet are as follows:

|   | December 31,  |               |
|---|---------------|---------------|
|   | 2011          | 2010          |
| Net deferred tax:   |               |               |
| Net operating loss carry-forward  | \$ 8,205,788  | \$ 8,579,095  |
| Depreciation and amortization (liability)   | (834,890 )    | (635,698 )    |
| Bad debt and note receivable allowance  | 2,161         | 142           |
| Related party interest  | 56,746        | 74,464        |
| Inventory allowance   | 58,238        | 58,445        |
| Credit carryforwards  | 13,920        | 59,525        |
| Stock options expense   | 730,778       | 407,869       |
| Payroll and director's fee  | 22,857        | 156,611       |
| Other   | 203,797       | 199,282       |
|   | 8,459,395     | 8,899,735     |
| Less: Valuation allowance   | (9,194,219 )  | (9,396,835 )  |
|   | \$ (734,824 ) | \$ (497,100 ) |
| Goodwill portion of net deferred tax – Presented as deferred income taxes (Long term liabilities) |               |               |
|   | \$ (751,148 ) | \$ (608,554 ) |
| Other net deferred tax – Presented as part of Other Assets  |               |               |
|   | \$ 16,324     | \$ 111,454    |

On January 1, 2007 the Company adopted the provisions of new accounting guidance regarding uncertain income tax positions. This guidance is found under FASB ASC Topic 740 "Income Taxes" ("ASC 740"). ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on the recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition associated with income tax liabilities.

As a result of the implementation of ASC 740, the Company recognized an increase in liabilities for unrecognized tax benefits of \$245,800, which was accounted for as an increase in the January 1, 2007 accumulated deficit. Interest recorded per ASC 740 is recorded as part of interest expense, net in the Company's statements of operations.

A reconciliation of the ASC 740 adjustments is as follows:

|                        | Year Ended December 31, |           |
|------------------------|-------------------------|-----------|
|                        | 2011                    | 2010      |
| Beginning Balance      | \$305,425               | \$289,525 |
| Interest and penalties | 15,900                  | 15,900    |
| Ending Balance         | \$321,325               | \$305,425 |

Long term deferred income tax liabilities totaled \$751,148 and \$608,554 as of December 31, 2011 and 2010, respectively, and include a tax basis difference related to the Company's indefinite lived intangible asset, where the Company determined that it would no longer be able to support the use of the deferred tax asset related to its net operating losses to offset the liability.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2011 and 2010, Talon International, Inc. had Federal net operating loss carry-forwards (or “NOLs”) of approximately \$19.9 million and \$20.4 million, respectively, and State NOLs of \$21.1 million and \$22.5 million, respectively. The Federal NOL and State NOL are available to offset future taxable income through 2031. Section 382 of the Internal Revenue Code places a limitation on the realizability of net operating losses in future periods if the ownership of the Company has changed more than 50% within a three-year period. Due to the Recapitalization Agreement signed between the Company and CVC on July 30, 2010 (See note 4 and Note 5) the application of I.R.C. Section 382 is required. The Company’s estimated calculation of the annual NOL limitation is approximately \$2.2 million for each of the next five years and \$0.7 million up to 20 years from the date of the transaction. The annual limitation reduced the Company’s NOL carry-forwards by approximately \$46 million for the Federal NOL and \$12 million for the State NOL. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax benefit carry-forwards. Deferred tax liabilities and assets at the end of each period are determined using enacted tax rates. The Company records deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if it believes that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided.

The provisions of ASC 740 require the establishment of a valuation allowance unless, based on currently available information and other factors, it is more likely than not that all or a portion of a deferred tax asset will be realized. ASC 740 provides an important factor in determining whether a deferred tax asset will be realized is whether there has been sufficient income realized in recent years and whether sufficient income is expected to be realized in future years to utilize the deferred tax asset.

In 2011, 2010 and 2009, the Company determined, based upon its cumulative operating losses, that it was not more likely than not that it would fully realize most of its domestic and foreign deferred tax assets in the future years. Accordingly, at December 31, 2011, and 2010 the Company recorded a valuation allowance of \$9.2 million and \$9.4 million, respectively; which reduces the carrying value of its net deferred tax assets.

The Company intends to maintain a valuation allowance for its deferred tax assets until sufficient evidence exists to support the reversal or reduction of the allowance. At the end of each period, the Company will review supporting evidence, including the performance against sales and income projections, to determine if a removal of the valuation allowance is warranted. If in future periods it is determined that it is more likely than not that the Company will be able to recognize all or a greater portion of its deferred tax assets, the Company will at that time reduce or reverse the valuation allowance. The Company believes that its estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change, dependent upon events that may or may not occur and because the impact of recording a valuation allowance may be material to the assets reported on its balance sheet and results of operations.

In 2011 there were no undistributed earnings from the Company’s foreign subsidiaries. In 2010 and 2009, the Company included in its consolidated U.S. federal tax return approximately \$34,000 and \$602,000, respectively a deemed dividend due to earnings from the Company’s foreign subsidiary.

Tax years subject to examination by the tax authorities for Talon International, Inc. (US) are 2007 through 2011 and for the foreign subsidiaries, 2005 through 2011.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 9—COMMITMENTS AND CONTINGENCIES

## Operating Leases

The Company is a party to a number of non-cancelable operating lease agreements involving buildings and equipment, which expire at various dates through 2014. The Company accounts for its leases in accordance with FASB ASC 840 “Leases”, whereby step provisions, escalation clauses, tenant improvement allowances, increases based on an existing index or rate, and other lease concessions are accounted for in the minimum lease payments and are charged to the statement of operations on a straight-line basis over the related lease term.

The future minimum lease commitments at December 31, 2011 are approximately as follows:

| Years Ending December 31, | Amount     |
|---------------------------|------------|
| 2012                      | \$ 519,000 |
| 2013                      | 273,000    |
| 2014                      | 148,000    |
| Total minimum payments    | \$ 940,000 |

Total rental expense for the years ended December 31, 2011, 2010 and 2009 aggregated \$629,699, \$651,285 and \$843,390, respectively.

## Profit Sharing Plan

In October 1999, the Company established a 401(k) profit-sharing plan for the benefit of eligible employees. The Company may make annual contributions to the plan as determined by the Board of Directors.

Total contributions for the years ended December 31, 2011, 2010 and 2009 amounted to \$21,184, \$16,750, \$14,898, respectively.

## Contingencies

On April 16, 2004, the Company originally filed suit against Pro-Fit Holdings, Limited in the U.S. District Court for the Central District of California – Tag-It Pacific, Inc. v. Pro-Fit Holdings, Limited, CV 04-2694 LGB (RCx) -- asserting various contractual and tort claims relating to our exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. Other related actions were subsequently filed by the parties. In 2008 Pro-Fit and certain related companies were placed into administration in the United Kingdom and filed petitions under Chapter 15 of Title 11 of the United States Code. Consequently, all litigation against Pro-Fit was stayed. In September 2011, the Company signed a Settlement Agreement and Release with Pro-Fit and the other parties involved in the litigation and administration proceedings. The Settlement Agreement provided for the unconditional release of Talon and related entities from all claims involved in the matter, a stipulation requesting that the US District Court dismiss the action, and our acquisition of all of the U.S. patents, licenses, rights and technology associated with our former exclusive license. The Settlement Agreement provided for no damages paid by any party and for dismissal of all actions with prejudice, and was formally completed by the parties in March 2012.

The Company currently has pending other claims and complaints that arise in the ordinary course of the Company's business. The Company believes that it has meritorious defenses to these claims and that the claims are either covered by insurance or would not have a material effect on the Company's consolidated financial position or results of operations if adversely determined against the Company.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In November 2002, the FASB issued Topics of the FASB ASC 460-10, "Guarantees" ("ASC 460-10") and FASB ASC 850-10, "Related Party Disclosures" ("ASC 850-10"). The following is a summary of the Company's agreements that it has determined are within the scope of ASC 460-10 and ASC 850-10:

- In accordance with the bylaws of the Company, officers and directors are indemnified for certain events or occurrences arising as a result of the officer or director's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws is minimal and therefore, the Company has not recorded any related liabilities.
- The Company enters into indemnification provisions under its agreements with investors and its agreements with other parties in the normal course of business, typically with suppliers, customers and landlords. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by the Company with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities.

NOTE 11 - SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

The Company manufactures and distributes a full range of zipper, trim and waistband items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. The Company's organization is based on divisions representing the major product lines, and the Company's operating decisions use these divisions to assess performance, allocate resources and make other operating decisions. Within these product lines there is not enough difference between the types of products to justify segmented reporting by product type or to account for these products separately. The net revenues and operating margins for the three primary product groups are as follows:

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

|                        | Year Ended December 31, 2011 |              |         |              |
|------------------------|------------------------------|--------------|---------|--------------|
|                        | Talon                        | Trim         | Tekfit  | Consolidated |
| Net sales              | \$22,612,784                 | \$19,047,959 | \$7,764 | \$41,668,507 |
| Cost of goods sold     | 16,481,686                   | 11,981,505   | 1,550   | 28,464,741   |
| Gross profit           | \$6,131,098                  | \$7,066,454  | \$6,214 | 13,203,766   |
| Operating expenses     |                              |              |         | \$11,864,518 |
| Income from operations |                              |              |         | \$1,339,248  |

|                        | Year Ended December 31, 2010 |              |            |              |
|------------------------|------------------------------|--------------|------------|--------------|
|                        | Talon                        | Trim         | Tekfit     | Consolidated |
| Net sales              | \$24,517,016                 | \$16,936,082 | \$6,649    | \$41,459,747 |
| Cost of goods sold     | 18,141,430                   | 10,771,096   | 86,829     | 28,999,355   |
| Gross profit           | \$6,375,586                  | \$6,164,986  | \$(80,180) | 12,460,392   |
| Operating expenses     |                              |              |            | 10,988,984   |
| Income from operations |                              |              |            | \$1,471,408  |

|                        | Year Ended December 31, 2009 |              |          |              |
|------------------------|------------------------------|--------------|----------|--------------|
|                        | Talon                        | Trim         | Tekfit   | Consolidated |
| Net sales              | \$21,341,132                 | \$17,274,158 | \$60,500 | \$38,675,790 |
| Cost of goods sold     | 16,590,224                   | 10,741,595   | 31,397   | 27,363,216   |
| Gross profit           | \$4,750,908                  | \$6,532,563  | \$29,103 | 11,312,574   |
| Operating expenses     |                              |              |          | 11,023,498   |
| Income from operations |                              |              |          | \$289,076    |

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company distributes its products internationally and has reporting requirements based on geographic regions. Long-lived assets are attributed to countries based on the location of the assets and revenues are attributed to countries based on customer delivery locations, as follows:

| Sales:        | Year Ended December 31, |              |              |
|---------------|-------------------------|--------------|--------------|
|               | 2011                    | 2010         | 2009         |
| United States | \$3,519,137             | \$3,574,386  | \$3,396,705  |
| Hong Kong     | 14,695,433              | 14,509,155   | 13,131,762   |
| China         | 9,557,952               | 10,412,168   | 8,990,718    |
| Bangladesh    | 2,092,993               | 2,546,500    | 2,008,869    |
| Other         | 11,802,992              | 10,417,538   | 11,147,736   |
| Total         | \$41,668,507            | \$41,459,747 | \$38,675,790 |

## Long-lived Assets:

|               | December 31, |             |             |
|---------------|--------------|-------------|-------------|
|               | 2011         | 2010        | 2009        |
| United States | \$4,443,691  | \$4,623,448 | \$4,956,855 |
| Hong Kong     | 629,373      | 884,344     | 1,193,617   |
| China         | 129,977      | 182,980     | 236,768     |
| Other         | 319          | 2,306       | 4,097       |
| Total         | \$5,203,360  | \$5,693,078 | \$6,391,337 |

## NOTE 11 - MAJOR CUSTOMERS AND VENDORS

For the years ended December 31, 2011, 2010 and 2009, the Company's three largest customers represented approximately 8%, 9% and 9%, respectively, of consolidated net sales.

Three vendors, each representing more than 10% of the Company's purchases, accounted for approximately 31% of the Company's purchases for the year ended December 31, 2011. Four vendors, each representing more than 10% of the Company's purchases, accounted for approximately 43% of the Company's purchases for the year ended December 31, 2010. Three vendors, each representing more than 9% of the Company's purchases, accounted for approximately 38% of the Company's purchases for the year ended December 31, 2009.

Included in accounts payable and accrued expenses at December 31, 2011 and 2010 is \$3,663,146 and \$1,923,704 due to these vendors.

## NOTE 12 - RELATED PARTY TRANSACTIONS

On July 30, 2010, the Company entered into a Recapitalization Agreement with CVC (See Note 4 and Note 5). As a result of this transaction CVC (currently the sole holder of the Series B Preferred Stock) became a majority stockholder in the company. Commencing August 1, 2010, a \$5,000 monthly debt monitoring fee has been paid to CVC, and a \$60,000 fee was paid to CVC in consideration of CVC entering into an amendment to the Loan Agreement during the third quarter of 2010. The Company paid to CVC an additional Loan commitment fee in the amount of \$50,000 during the third quarter of 2011.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Notes payable to related parties includes a note and associated interest due to Lonnie D. Schnell, the Chief Executive Officer and Chief Financial Officer of the Company. The note was issued on August 6, 2009 in partial satisfaction of 2008 annual incentive amounts to which Mr. Schnell was entitled. The balance of the note payable and accrued interest expense due to Mr. Schnell at December 31, 2011 and 2010 was \$41,159 and \$38,768, respectively, and the balance was paid in full subsequent to the year ending December 31, 2011.

Notes payable to related parties also includes demand notes and advances to parties related to or affiliated with Mark Dyne. The balance of demand notes payable and interest expense due to Mark Dyne and affiliated parties at December 31, 2011 and December 31, 2010 was \$198,783 and \$236,448, respectively. On August 2, 2011 the Promissory Note dated as of June 30, 1991 in favor of Harold Dyne was paid in full, including accrued interest, for \$44,340. Subsequent to the year ending December 31, 2011 the note in favor of Monto Holdings Pty, Ltd was paid in full, including accrued interest, for \$199,798.

In March 2010, a consulting agreement with Diversified Consulting, LLC, a company owned by Mark Dyne expired. Accrued consulting fees and related interest amounted to \$0 and \$164,761, as of December 31, 2011 and 2010, respectively, in consideration of the final payments under the agreement. Consulting fees and related interest to Diversified Consulting, LLC amounted to \$6,464, \$63,194 and \$401,568 for the years ended December 31, 2011, 2010, and 2009, respectively. On August 4, 2011 the balance of \$83,725 was paid in full to Diversified Consulting, LLC.

Colin Dyne is a director, officer and significant stockholder in People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. and William Rast Sourcing ("PLI"). Also, Colin Dyne is the brother of both Mark Dyne, the Chairman of the board of directors of the Company, and Larry Dyne, the President of the Company. The Company had sales to PLI, during the years ended December 31, 2011, 2010 and 2009 of \$142,530, \$120,270 and \$207,322, respectively. Accounts receivable of \$3,112 and \$26,739 were outstanding from PLI at December 31, 2011 and 2010, respectively.

In November 2009, the Company entered into an agreement with Colin Dyne to pay a commission equal to 7% of the collected revenues associated with the sales of products to a specific retail brand, with a portion of the commission earned applied to a note receivable balance that was then outstanding. During the years ended December 31, 2011, 2010 and 2009 commissions of \$72,640, \$172,506 and \$13,269 were earned under this agreement, respectively, and for the year ended December 31, 2010 commissions of \$27,057 were applied to the note receivable balance. The Note Receivable from Related Party, net at December 31, 2009 represented the unsecured note and accrued interest receivable due from Colin Dyne, and included a valuation reserve for the full amount due. The note bore interest at 7.5% and was due on demand. On June 29, 2010, the Company sold the Note Receivable with all of the Company's rights, title and interest therein to an unrelated third party for cash proceeds of \$275,000. The amount received was recorded as a recovery of bad debts.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 13 - QUARTERLY RESULTS (UNAUDITED)

Quarterly results for the years ended December 31, 2011 and 2010 are reflected:

|  | Year Ended December 31, 2011 |              |              |              |
|--|------------------------------|--------------|--------------|--------------|
|  | 1st                          | 2nd          | 3rd          | 4th          |
| Net sales  | \$9,228,193                  | \$12,752,281 | \$9,404,648  | \$10,283,385 |
| Gross profit   | \$2,890,553                  | \$4,063,338  | \$2,827,787  | \$3,422,088  |
| Income (loss) from operations  | \$(290,505 )                 | \$1,001,138  | \$(157,455 ) | \$786,070    |
| Net income (loss)  | \$(400,928 )                 | \$656,325    | \$(126,020 ) | \$599,756    |
| Net income (loss) per share  | \$(0.02 )                    | \$0.03       | \$(0.01 )    | \$0.03       |
| Basic and diluted net loss per share applicable to Common Shareholders | \$(0.05 )                    | \$(0.00 )    | \$(0.04 )    | \$(0.01 )    |

  

|  | Year Ended December 31, 2010 |              |               |             |
|--|------------------------------|--------------|---------------|-------------|
|  | 1st                          | 2nd          | 3rd           | 4th         |
| Net sales  | \$8,235,260                  | \$14,973,072 | \$9,277,334   | \$8,974,081 |
| Gross profit   | \$2,436,693                  | \$4,339,237  | \$2,714,056   | \$2,970,406 |
| Income (loss) from operations  | \$(175,702 )                 | \$1,697,769  | \$(98,181 )   | \$47,522    |
| Net income (loss)  | \$(847,643 )                 | \$646,676    | \$(1,242,166) | \$(23,687 ) |
| Net income (loss) per share  | \$(0.04 )                    | \$0.03       | \$(0.06 )     | \$(0.00 )   |
| Basic and diluted net loss per share applicable to Common Shareholders | \$(0.04 )                    | \$0.03       | \$(0.13 )     | \$(0.03 )   |

The Company typically experiences seasonal fluctuations in sales volume consistent with the purchase demands of the apparel industry. In most years, these seasonal fluctuations result in lower sales volumes for the Company's business in the first and fourth quarters of each year due to the seasonal buying patterns by the majority of the customers. The apparel retailers typically experience higher sales volumes during the second quarter associated with back-to-school sales and in the fourth quarter in association with year-end holiday purchases. Sales of the Company's products can typically precede the retail sales patterns by 90 to 150 days. Backlogs of sales orders are not considered material in the industries in which the Company competes, which reduces the predictability and reinforces the volatility of these cyclical buying patterns on the Company's sales volume.

During 2010 the Company recorded loss on extinguishment of debt in amount of \$570,915 and related party note recovery in amount of \$275,000. Quarterly and year-to-date computations of per share amounts are made independently. Therefore, the sum of per share amounts for the quarters may not agree with the per share amounts for the year.

## NOTE 14 – SUBSEQUENT EVENTS

The Company evaluated subsequent events after the balance sheet date of December 31, 2011 through the date these audited financial statements were issued.



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

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Evaluation of Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act.

As of the end of the period covered by this report, management, with the participation of Lonnie D. Schnell, our principal executive and principal financial officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, Mr. Schnell concluded that these disclosure controls and procedures were effective as of the end of the period covered by this Annual Report on Form 10-K.

**Management's Report on Internal Control over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. In order to evaluate the effectiveness of internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act, the Company's management has conducted an assessment, including testing, using the criteria in Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Our system of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Based on its assessment, our management has concluded that control over financial reporting was effective as of December 31, 2011.

Pursuant to applicable law, this annual report is not required to include an attestation report of our registered public accounting firm regarding internal control over financial reporting.

**Changes in Internal Control over Financial Reporting**

No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the fourth quarter of our fiscal year ended December 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

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## PART III

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

The following table sets forth the name, age and position of each of our executive officers and directors as of March 26, 2012.

| Name                       | Age | Position   |
|----------------------------|-----|--|
| Directors:                 |     |  |
| Mark Dyne (1)(3)           | 51  | Chairman of the Board of Directors<br>Chief Executive Officer, Chief Financial<br>Officer and Director |
| Lonnie D. Schnell          | 63  | Director   |
| David Ellis (2)            | 48  | Director   |
| Mark J. Hughes (2)         | 40  | Director   |
| Michael Francis Snyder (2) | 59  | Director   |
| Other Executive Officers:  |     |  |
| Larry Dyne (3)             | 39  | President  |
| James E. Reeder            | 54  | Vice President, Corporate Controller   |

(1) Messrs. Dyne and Schnell were elected by holders of Common Stock, and the seats they occupy on the Board will be filled by a vote of the holders of Common Stock, voting as a separate class.

(2) Messrs. Ellis, Hughes and Snyder were appointed by the sole holder of Series B Preferred Stock, and the seats they occupy on the Board will be filled by a vote of the holders of Series B Preferred Stock, voting as a separate class.

(3) Mark Dyne and Larry Dyne are brothers.

## Directors:

## Mark Dyne

Mr. Dyne has served as Chairman of the Board of Directors since 1997. Mr. Dyne currently serves as the Chief Executive Officer and the Managing Partner of Europlay Capital Advisors, LLC, a merchant banking and advisory firm. Mr. Dyne previously served on the Board of Directors of Skype Global S.a.r.l. the world's leader in V.O.I.P. communications as well as Atrinsic, Inc. Mr. Dyne also served as Chairman and Chief Executive Officer of Sega Gaming Technology Inc. (USA), a gaming company, and Chairman and Chief Executive Officer of Virgin Interactive Entertainment Ltd., based in London, England. Mr. Dyne was a founder of Packard Bell NEC Australia Pty. Ltd., and he was a founder and former director of Sega Ozisoft Pty Ltd. Mr. Dyne was nominated to our board of directors for his extensive domestic and international management experience, and knowledge of associated industry practices and trends.

Lonnie D. Schnell Mr. Schnell joined us in January 2006 as our Chief Financial Officer, was appointed as Chief Executive Officer in February 2008 and has served on our Board of Directors since May 2008. Mr. Schnell served as Vice President of Finance for Capstone Turbine Corporation, a manufacturer of micro-turbine electric generators from 2004 until 2005. From 2002 to 2004 Mr. Schnell served as Chief Financial Officer of EMSource, LLC, an electronic manufacturing service company. Prior to EMSource, in 2002, Mr. Schnell served as Chief Financial Officer of Vintage Capital Group, a private equity investment firm. From 1999 through 2002, Mr. Schnell served as Chief Financial Officer of Need2Buy, Inc. a business-to-business internet marketplace for electronic components. Mr. Schnell has completed an executive MBA program with the Stanford University Executive Institute, and earned his Bachelor of Science in Accounting at Christian Brothers University. Mr. Schnell is a Certified Public Accountant with experience in the international accounting firm of Ernst & Young LLP. Mr. Schnell was nominated to our Board of Directors for his extensive domestic and international management experience, and knowledge of associated industry practices and trends, and for his financial management expertise.

David Ellis David Ellis has served on our Board of Directors since October 2010. Mr. Ellis is a co-founder of GemCap, an equity investor in low and middle-market sized companies and provider of asset-based loans, ranging from \$1 million to \$10 million, as a senior-secured lender. Through 2006, Mr. Ellis served as the President of Buxbaum Group, which he initially joined in 1988. Following a three-year hiatus from Buxbaum Group starting in 1991, Mr. Ellis rejoined the company in 1994. Buxbaum Group consisted of the following five companies which reported to Mr. Ellis: Buxbaum Company, Buxbaum Group, Buxbaum-Century, BC Commercial Finance and Pathway Strategic Partners. While at Buxbaum Group, Mr. Ellis gained twenty years of experience in the acquisition, insolvency and turnaround management businesses. Mr. Ellis was nominated to our Board of Directors for his extensive domestic and international management experience, and knowledge of associated industry practices and trends, and for his financial and investment management expertise.

Mark J. Hughes Mark J. Hughes has served on our Board of Directors since July 2010. Mr. Hughes currently serves as a Managing Director at The Comvest Group, a private investment firm focused on providing equity and debt capital to lower middle-market companies. From July 2005 until joining ComVest, Mr. Hughes was a Managing Director at Tejas Securities Group, an investment and merchant bank focused on distressed debt, high yield and special situations. From March 1998 to June 2005, Mr. Hughes served as a Managing Director in the Investment Banking Group and an Equity Research Analyst at C.E. Unterberg, Towbin, an investment bank that specialized on advising, financing and investing in middle-market healthcare and technology companies. From 1996 to 1998, Mr. Hughes worked in Global Markets as a Foreign Exchange Analyst at Deutsche

Bank. Prior to Deutsche Bank, Mr. Hughes spent three years as a Senior Auditor in the Hedge Fund and Broker Dealer Practice of Goldstein, Golub, & Kessler, LLC. Mr. Hughes was a CPA and received his B.S. from Rutgers College, Rutgers School of Business. Mr. Hughes was nominated to our board of directors for his extensive experience in private equity, capital markets, mergers and acquisitions, and corporate finance matters, and his leadership skills enable him to provide support to the Company in areas of operations, finance, and strategy.

Michael Francis Snyder

Michael Francis Snyder has served on our Board of Directors since July 2010. Mr. Snyder is a partner of GSC Consultants, a service industry consulting and advisory firm specializing in strategic growth and turnaround situations for troubled service companies. Prior to forming GSC in 2007, Mr. Snyder was Chief Executive Officer and Director of Vonage Holdings, Inc. (NYSE: VG), a leading supplier to the telecommunications industry in VOIP services, since February 2006. From 1997 to February 2006, Mr. Snyder served as President of ADT Security Services, Inc., a subsidiary of Tyco International Ltd. Mr. Snyder joined ADT in 1977 and served in various positions prior to 1997. Mr. Snyder was nominated to our Board of Directors for his extensive domestic and international management experience, and knowledge of associated industry practices and trends, and for his strategic growth management expertise.

#### Other Executive Officers

Larry Dyne

Larry Dyne was appointed as our President in May 2009. He has been our employee since 1992, and was formerly Executive Vice President of Sales as well as vice president of product development and global sourcing, and vice president of trim sales. Through these positions, Mr. Dyne has established extensive and long-term relationships with the world's top brands and clothing retailers. He was also formerly responsible for domestic production for all printing.

James E. Reeder

James E. Reeder joined us in May 2009 and was appointed Vice President, Corporate Controller. From January 2007 to September 2008, Mr. Reeder served as Chief Financial Officer at Sheffield Manufacturing, an aerospace parts manufacturer and at Data Exchange Corporation, an international provider of supply chain solutions. From January 2002 to October 2006, Mr. Reeder was Vice President Finance for Special Devices, Inc., a manufacturer of automotive safety devices and was previously Chief Financial Officer for Power Lift Corporation, a distributor of Caterpillar materials and equipment. Mr. Reeder also served in various senior financial roles at Avery Dennison Corporation for approximately fourteen years. Mr. Reeder has an MBA in Finance and Strategic Planning from the University of California at Berkeley and a B.S., Economics Summa Cum Laude from California State Polytechnic University, Pomona.

#### Board Composition and Nominations

On July 30, 2010, we entered into a Recapitalization Agreement with CVC California, LLC, pursuant to which we issued to CVC an aggregate of 407,160 shares of a newly created senior series of preferred stock, designated Series B Convertible Preferred Stock, in payment of the full amount of the debt owed by us to CVC under our Loan Agreement with CVC. Each share of Series B Preferred Stock is convertible into 100 shares of Common Stock. The Series B Preferred Stock has other rights, preferences, privileges and restrictions, including a liquidation preference, redemption rights and class voting rights, which are summarized in Note 5 in the accompanying Notes to Consolidated Financial Statements.

In connection with the Recapitalization Agreement our Board of Directors was reconfigured to consist of five members, with three members designated by the Series B Preferred Stockholders to serve as Series B Directors.

Concurrently with execution of the Recapitalization Agreement, we entered into a Stockholders Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of our Board of Directors, and Larry Dyne, our President, providing for, among other agreements, the following with respect to election of directors:

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- CVC agreed that in connection with any director nominees to be submitted to holders of our common stock for election at a stockholders' meeting, a committee of our Board comprised solely of directors then serving on the Board who were not elected or appointed by holders of Series B Preferred Stock, acting by majority vote, shall have the right to designate all of the Board's nominees for director to be elected by holders of our Common Stock; and
- CVC agreed that in connection with any election of directors submitted to our stockholders for election at a stockholders' meeting, CVC will attend the stockholders' meeting, in person or by proxy, and vote (or cause to be voted) all of CVC's shares of our voting stock in favor of the Board's nominees for director.

#### Audit Committee and Audit Committee Financial Expert

The Company is not a "listed company" under SEC rules and is therefore not required to have a separate audit committee comprised of independent directors. Our full Board of directors performs the functions of the audit committee. The Company has, however, determined that as of December 31, 2011, each of Messrs. Ellis and Snyder is "independent" as that term is defined in Section 5605 of the NASDAQ Marketplace Rules applicable to companies listed on The NASDAQ Stock Market, and has also determined that each of Messrs. Dyne, Schnell, Ellis and Snyder is an "audit committee financial expert" as defined in Item 407(d)(5) of Regulation S-K.

#### Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires our executive officers, directors and persons who own more than ten percent of a registered class of our equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Executive officers, directors and greater-than-ten percent stockholders are required by Securities and Exchange Commission regulations to furnish us with all Section 16(a) forms they file. Based solely on our review of the copies of the forms received by us and written representations from certain reporting persons that they have complied with the relevant filing requirements, we believe that, during the year ended December 31, 2011, all of our executive officers, directors and greater-than-ten percent shareholders complied with all Section 16(a) filing requirements.

#### Code of Ethics

We have adopted a Code of Ethical Conduct that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as well as to our other employees and directors generally. A copy of our Code of Ethical Conduct is filed as an exhibit to our Annual Report on Form 10-K.

### ITEM 11. EXECUTIVE COMPENSATION

#### COMPENSATION DISCUSSION AND ANALYSIS

The compensation committee of the Board was previously responsible for determining the compensation to be paid to our officers and directors, with recommendations from management as to the amount and/or form of such compensation. Since the elimination of the compensation committee on July 30, 2010, the full Board of Directors now performs this function. While our Board may utilize the services of consultants in determining or recommending the amount or form of executive and director compensation, we do not at this time employ consultants for this purpose, and not employ compensation consultants at any time during 2011.



Our executive compensation program is administered by the Board of Directors. The Board of Directors is responsible for, among other functions: (1) reviewing and approving corporate goals and objectives relevant to the Chief Executive Officer's compensation and evaluating the performance of the Chief Executive Officer in light of these corporate goals and objectives; (2) administering our incentive-compensation and equity based plans; and (3) negotiating, reviewing and recommending the annual salary, bonus, stock options and other benefits, direct and indirect, of the Chief Executive Officer, and other current and former executive officers. The Board of Directors also has the authority to select and/or retain outside counsel, compensation and benefits consultants, or any other consultants to provide independent advice and assistance in connection with the execution of its responsibilities.

Our named executive officers for 2011 were as follows:

- Lonnie D. Schnell, Chief Executive Officer & Chief Financial Officer;
- Larry Dyne, President; and
- James E. Reeder, Vice President, Corporate Controller.

#### Compensation Philosophy

Our executive compensation program is designed to drive company performance to maximize shareholder value while meeting our needs and the needs of our employees. The specific objectives of our executive compensation program include the following:

- Alignment – to align the interests of executives and stockholders through equity-based compensation awards;
- Retention – to attract, retain and motivate highly qualified, high performing executives to lead our continued growth and success; and
- Performance – to provide rewards commensurate with performance by emphasizing variable compensation that is dependent upon the executive's achievements and company performance.

In order to achieve these specific objectives, our executive compensation program is guided by the following core principles:

- Rewards under incentive plans are based upon our short-term and longer-term financial results and increasing stockholder value;
- Senior executive pay is set at sufficiently competitive levels to attract, retain and motivate highly talented individuals who are necessary for us to achieve our goals, objectives and overall financial success;
- Compensation of an executive is based on such individual's role, responsibilities, performance and experience, taking into account the desired pay relationships within the executive team; and
- Our executive compensation program places a strong emphasis on performance-based variable pay to ensure a high pay-for-performance culture. Annual performance of our company, primarily in terms of performance measured by an adjusted earnings before interest, taxes, depreciation and amortization for the year, and the executive are taken into account in determining annual bonuses that ensures a high pay-for-performance culture.



## Compensation Elements

We compensate senior executives through a variety of components, including base salary, annual incentives, equity incentives and benefits and perquisites, in order to provide our employees with a competitive overall compensation package. The mix and value of these components are impacted by a variety of factors, such as responsibility level, individual negotiations and performance and market practice. The purpose and key characteristics for each component are described below.

### Base Salary

Base salary provides executives with a steady income stream and is based upon the executive's level of responsibility, experience, individual performance and contributions to our overall success. Competitive base salaries, in conjunction with other pay components, enable us to attract and retain highly talented executives. The Board of Directors typically sets base salaries for our senior executives at market levels. However, base salaries will vary in practice based upon an individual's performance, individual experience and negotiations and for changes in job responsibilities.

### Management Incentive Bonuses

Management incentive bonuses are a variable performance-based component of compensation. The primary objective of an annual incentive bonus is to reward executives for achieving corporate and individual goals and to align a meaningful portion of total pay opportunities for executives and other key employees to the attainment of our company's performance goals. These awards are also used as a means to recognize the contribution of our executive officers to overall financial, operational and strategic success.

### Equity Incentives

Equity incentives are intended to align senior executive and stockholder interests by linking a meaningful portion of executive pay to long-term stockholder value creation and financial success over a multi-year period. Equity incentives are also provided to our executives to attract and enhance the retention of executives and other key employees and to facilitate stock ownership by our senior executives. The Board of Directors also considers individual and company performance when determining long-term incentive opportunities.

### Health & Welfare and 401-K Benefits

The named executive officers participate in a variety of retirement, health and welfare and paid time-off benefits designed to enable us to attract and retain our workforce in a competitive marketplace. Health and welfare and paid time-off benefits help ensure that we have a productive and focused workforce.

### Severance and Change of Control Arrangements

We do not have a formal plan for severance or separation pay for our employees, but we typically include a severance provision in the employment agreements of our executive officers that is triggered in the event of involuntary termination without cause or in the event of a change in control.

In order to preserve the morale and productivity and encourage retention of our key executives in the face of the disruptive impact of an actual or rumored change in control, we provide a bridge to future employment in the event that an executive's job is eliminated as a consequence of a change in control. This provision is intended to align executive and stockholder interests by enabling executives to consider corporate transactions that are in the best interests of the stockholders and other constituents without undue concern over whether the transactions may

jeopardize the executive's own employment. Our employment agreements with our current named executive officers provide a lump sum payment and benefits continuation as a result of an involuntary termination without cause or for good reason following a change in control, plus accelerated vesting of stock or option awards.

## Other Benefits

In order to attract and retain highly qualified executives, we provide some of our named executive officers, with automobile allowances that we believe are consistent with current market practices. Our executives also may participate in a 401(k) plan under which we match contributions for all employees up to 100% of an employee's contributions to a maximum of \$1,000 and subject to any limitations imposed by ERISA.

## Other Factors Affecting Compensation

### Accounting and Tax Considerations

We consider the accounting implications of all aspects of our executive compensation program. Our executive compensation program is designed to achieve the most favorable accounting (and tax) treatment possible as long as doing so does not conflict with the intended plan design or program objectives.

### Process for Setting Executive Compensation

When making pay determinations for named executive officers, the Board of Directors considers a variety of factors including, among others: (1) actual company performance as compared to pre-established goals, (2) overall company performance and size relative to industry peers, (3) individual executive performance and expected contribution to our future success, (4) changes in economic conditions and the external marketplace and (5) in the case of named executive officers, other than Chief Executive Officer, the recommendation of our Chief Executive Officer. Ultimately, the Board of Directors uses its judgment when determining how much to pay our executive officers. The Board of Directors evaluates each named executive officer's performance during the year against established goals, leadership qualities, business responsibilities, current compensation arrangements and long-term potential to enhance stockholder value. The opinions of outside consultants may also be taken into consideration in deciding what salary, bonus, long-term incentives and other benefits and severance to give each executive in order to meet our objectives stated above. The Board of Directors considers compensation information from data gathered from annual reports and proxy statements from companies that the Board of Directors generally considers comparable to us; compensation of other company employees for internal pay and equity purposes; and levels of other executive compensation plans from compensation surveys.

The Board of Directors sets the pay for the named executive officers and other executives, by element and in the aggregate, at levels that it believes are competitive and necessary to attract and retain talented executives capable of achieving our long-term objectives.

## Factors Considered

In administering the compensation program for senior executives, including named executive officers, the Board of Directors considers the following:

- Cash versus non-cash compensation. The pay elements are cash-based except for the long-term incentive program, which may be cash-based, equity-based, or a combination. In 2010, long-term incentive compensation included significant grants or restricted stock units to our Chief Executive Officer and to our President, which grants were made in connection with the recapitalization transaction that closed in July 2010;
- Prior year's compensation. The Board of Directors considers the prior year's bonuses and long-term incentive awards when approving bonus payouts or equity grants;



- Adjustments to Compensation. On an annual basis, and in connection with setting executive compensation packages, the Board of Directors reviews our operating income growth, earnings before interest and taxes growth, earnings per share growth, cash flow growth, operating margin, revenue growth and total stockholder return performance. In addition, the Board of Directors considers peer group pay practices, emerging market trends and other factors. No specific weighing is assigned to these factors nor are particular targets set for any particular factor. Total compensation from year to year can vary significantly based on our and the individual executive's performance; and
- Application of discretion. It is our policy and practice to use discretion in determining the appropriate compensation levels considering performance.

#### REPORT OF COMPENSATION COMMITTEE

The full Board of Directors performs the functions of a compensation committee and is responsible for considering and making decisions regarding executive compensation and is responsible for administering our stock option and executive incentive compensation plans.

The Board of Directors has reviewed and discussed with management the Compensation Discussion and Analysis included in this report. Based on the review and discussion with management, the Board of Directors has determined that the Compensation Discussion and Analysis should be included in the Company's Annual Report on Form 10-K.

Board of Directors  
Mark Dyne  
Lonnie D. Schnell  
David Ellis  
Mark J. Hughes  
Michael Francis Snyder

March 26, 2012

#### EXECUTIVE COMPENSATION

##### Summary Compensation Table

The following table sets forth, as to each person serving as Chief Executive Officer and Chief Financial Officer during 2011 and the two mostly highly compensated executive officers other than the Chief Executive Officer and Chief Financial Officer at the end of the 2011 whose compensation exceeded \$100,000 (referred to as "named executive officers"), information concerning all compensation earned for services to us in all capacities for 2009, 2010 and 2011.

|                                      | Year | Salary     | Bonus<br>(1) | Stock<br>Awards (2) | Option<br>Awards<br>(2) | Non-Equity<br>Incentive<br>Plan<br>Compensation<br>(3) | All Other<br>Compensation<br>(4) | Total      |
|--------------------------------------|------|------------|--------------|---------------------|-------------------------|--|----------------------------------|------------|
| <b>Lonnie D. Schnell</b>             |      |            |              |                     |                         |  |                                  |            |
| Chief Executive Officer              | 2011 | \$ 349,519 | \$ 80,436    | \$ -                | \$ -                    | \$ -   | \$ 39,288                        | \$ 469,243 |
| and Chief Financial Officer          | 2010 | 324,615    | -            | 1,143,344           | -                       | 162,500  | 31,668                           | 1,662,127  |
|                                      | 2009 | 310,573    | -            | -                   | 51,418                  | 94,000   | 25,643                           | 481,634    |
| <b>Larry Dyne</b>                    |      |            |              |                     |                         |  |                                  |            |
| President                            | 2011 | 324,519    | 75,436       | -                   | -                       | -  | 22,693                           | 422,648    |
|                                      | 2010 | 299,615    | -            | 1,120,540           | -                       | 150,000  | 19,393                           | 1,589,548  |
|                                      | 2009 | 284,612    | -            | -                   | 37,462                  | 71,000   | 16,345                           | 409,419    |
| <b>James E. Reeder</b>               |      |            |              |                     |                         |  |                                  |            |
| Vice President, Corporate Controller | 2011 | 175,000    | 15,000       | -                   | 9,091                   | -  | 20,470                           | 219,561    |
|                                      | 2010 | 171,539    | 45,000       | -                   | -                       | -  | 15,868                           | 232,407    |
|                                      | 2009 | 100,439    | -            | -                   | 18,920                  | 22,500   | 6,512                            | 148,371    |

- (1) Bonus compensation consists of discretionary annual cash bonuses and cash awarded to the named executives based upon performance. Bonuses are reported for the year in which they were earned, and are generally paid in the first quarter of the subsequent year.
- (2) The amounts in this column represent the aggregate grant date fair value computed in accordance with ASC 718 with respect to option awards or stock awards granted in the applicable year. Pursuant to SEC rules, the amounts shown exclude the impact of estimated forfeitures related to service-based vesting conditions. For additional information on the valuation assumptions with respect to these grants, refer to Note 6 of our accompanying Notes to Consolidated Financial Statements in this Annual Report on Form 10-K. These amounts do not reflect the actual value that may be realized by the named executive officers which depends on the value of our shares in the future.
- (3) Non-equity incentive plan compensation for 2010 consists of awards from the EBITDA Bonus Plan, a cash incentive plan, which was established pursuant to our employment agreements with Mr. Schnell and Mr. Dyne signed on July 30, 2010. Non-equity incentive plan compensation for 2009 consists of awards to the named executive officers under the Management Incentive Plan, a cash incentive plan, which was established pursuant to our 2008 employment agreements with Mr. Schnell and Mr. Dyne for these and other executives. Incentives are reported in the year earned, and are paid in accordance with their terms in the subsequent year.

As described further below, options were granted in 2009 to Mr. Schnell and Mr. Dyne and a promissory note was issued to Mr. Schnell in satisfaction of bonus amounts to which such executives were entitled for fiscal 2008 in accordance with Management Incentive Plan, comprising \$53,230 and \$40,000 in bonus amounts for Mr. Schnell and Mr. Dyne, respectively, previously reported as 2008 non-equity incentive plan compensation to these executives in our 2008 Annual Report on Form 10-K.

(4) All other compensation consists of the following (amounts in dollars):

|                      | Year | Health and<br>medical<br>insurance<br>(a) | Life and<br>disability<br>insurance<br>(b) | 401k<br>contribution<br>(c) | Automobile<br>allowances | Total     |
|----------------------|------|---|--|-----------------------------|--------------------------|-----------|
| Lonnie D.<br>Schnell | 2011 | \$ 27,727                                 | \$ 301                                     | \$ 1,000                    | \$ 10,260                | \$ 39,288 |
|                      | 2010 | 21,397                                    | 301  | 1,000                       | 8,970                    | 31,668    |
|                      | 2009 | 17,802                                    | 301  | -                           | 7,540                    | 25,643    |
| Larry Dyne           | 2011 | 15,438                                    | 4,084                                      | 1,000                       | 2,171                    | 22,693    |
|                      | 2010 | 11,588                                    | 4,025                                      | 1,000                       | 2,780                    | 19,393    |
|                      | 2009 | 9,938                                     | 4,000                                      | -                           | 2,407                    | 16,345    |
| James E. Reeder      | 2011 | 19,169                                    | 301  | 1,000                       | -                        | 20,470    |
|                      | 2010 | 14,567                                    | 301  | 1,000                       | -                        | 15,868    |
|                      | 2009 | 5,362                                     | 150  | 1,000                       | -                        | 6,512     |

(a)Includes payments of medical premiums.

(b)Includes executive and group term life and disability insurance.

(c)Represents our contribution to 401k programs.

## Executive Compensation

Chief Executive Officer and Chief Financial Officer. The 2010 and 2011 base salary and other compensation for Lonnie Schnell, our Chief Executive Officer was determined in accordance with our employment agreements with him. The terms and conditions established in this agreement were the result of our consideration of our operating performance levels, at the time of entering into the agreement and for prior periods, comparative industry compensation levels and negotiations with Mr. Schnell. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies, and on July 30, 2010 Mr. Schnell was granted a restricted stock unit award (“RSU Award”) for 5,778,500 shares of our common stock. The RSU Award vested 50% on a date which was 13 months following the grant date, and vests an additional 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to full acceleration of vesting upon a change in control of the Company, as defined in the RSU Award agreement. The settlement of vested shares under the RSU Award is subject to non-revocable deferral elections delivered by Mr. Schnell. In addition to the long-term equity incentive, Mr. Schnell was entitled to receive an annual cash bonus in 2010 and 2011 in an amount equal to a percentage of his base salary upon Talon achieving actual adjusted earnings before interest, taxes, depreciation and amortization (“EBITDA”) within a range, starting at 80%, of target adjusted EBITDA.



The EBITDA bonus award under Mr. Schnell's employment agreement for 2010 and 2011 is shown in the table above as non-equity incentive plan compensation. The target EBITDA was not achieved for 2011, and therefore no non-equity incentive plan compensation was earned. However, Mr. Schnell was awarded a discretionary incentive cash bonus for 2011, shown in the table above under Bonus, based on the performance of the Company and Mr. Schnell's individual performance and contributions.

In 2009, a cash incentive, referred to as the Management Incentive Program ("MIP"), was established as provided in Mr. Schnell's employment agreement setting aside 12% of our EBITDA, and selected expenses associated with non-operating charges, for annual bonus awards to him and the other senior executives. The MIP fund awards are shown in the table above as non-equity incentive plan compensation.

In 2009, Mr. Schnell was awarded (a) a 10-year non-qualified stock option to purchase 700,000 shares of common stock, which option was immediately vested and has an exercise price of \$0.09 per share, and (b) a promissory note in the principal sum of \$35,000, which note accrued interest at the rate of 6.0% per annum from April 16, 2009 and matures on the earlier of December 31, 2011 and a date that is ten business days following the date Mr. Schnell's employment with us terminates for any reason. The 2008 annual incentive bonuses awarded to Mr. Schnell in the form of options and a promissory note were paid in 2009 in satisfaction of all bonus amounts to which he was entitled for fiscal 2008 in accordance with his employment agreement, including \$53,230 in bonus payments for Mr. Schnell previously reported as 2008 non-equity incentive plan compensation our 2008 Annual Report on Form 10-K.

President. The 2010 and 2011 base salary and other compensation for Larry Dyne, our President was determined in accordance with our employment agreements with him. The terms and conditions established in this agreement were the result of our consideration of our operating performance levels at the time of entering into the agreements and for prior periods, comparative industry compensation levels and negotiations with Mr. Dyne. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies, and on July 30, 2010 Mr. Dyne was granted a RSU Award for 5,778,500 shares of our common stock. The RSU Award vested 50% on a date which was 13 months following the grant date, and vests an additional 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to full acceleration of vesting upon a change in control of our Company, as defined in the RSU Award agreement. The settlement of vested shares under the RSU Award is subject to non-revocable deferral elections delivered by Mr. Dyne. In addition to the long term incentive, Mr. Dyne was entitled to receive an annual cash bonus in 2010 and 2011 in an amount equal to a percentage of his base salary upon Talon achieving actual adjusted EBITDA within a range, starting at 80%, of target adjusted EBITDA.

The EBITDA bonus award under Mr. Dyne's employment agreement for 2010 and 2011 is shown in the table above as non-equity incentive plan compensation. The target EBITDA was not achieved for 2011, and therefore no non-equity incentive plan compensation was earned. However, Mr. Dyne was awarded a discretionary incentive cash bonus for 2011, shown in the table above under Bonus, based on the performance of the Company and Mr. Dyne's individual performance and contributions.

For 2009, Mr. Dyne was eligible to participate in the MIP annual cash incentive plan, and was awarded a 10-year non-qualified stock option to purchase 510,000 shares of our common stock, which option was immediately vested and has an exercise price of \$0.09 per share. The 2008 annual incentive bonuses awarded to Mr. Dyne in the form of this option grant were paid in satisfaction of all bonus amounts to which he was entitled for fiscal 2008 in accordance with his employment agreement, including \$40,000 in bonus payments for Mr. Dyne previously reported as 2008 non-equity incentive plan compensation in our 2008 Annual Report on Form 10-K.



Vice President, Corporate Controller. The 2010 and 2011 compensation for James E. Reeder, our Vice President, Corporate Controller was in accordance with our at-will employment agreement with him. The terms and conditions established in this agreement were the result of our consideration of our operating performance levels, compensation levels for our previous corporate controller, comparative industry compensation levels and negotiations with Mr. Reeder. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies. Cash bonus is a discretionary bonus award based on performance.

In 2011 and 2009, long-term equity in the form of options for 100,000 and 200,000 shares of common stock, respectively, were granted to Mr. Reeder as an inducement to maximize performance and increase stockholder value. The option grants were established to vest monthly over a four-year term, after a minimum initial term of twelve months, to coincide with the objectives of our strategic plan. Mr. Reeder was a participant in the Management Incentive Plan for 2009. During the first year of employment, a bonus of not less than \$20,000 was guaranteed in the employment agreement. Bonuses for 2010 and 2011 are discretionary incentive bonuses awarded based on the performance of the Company and Mr. Reeder's individual performance and contributions.

#### Grants of Plan-Based Awards in Fiscal 2011

The following table provides information about equity-awards granted to each named executive officer in 2011.

| Name            | Grant Date (1) | Approval Date(1) | All Other      | Exercise or Base Price of Option Awards (\$/SH) (3) | Market Price on Grant Date (\$/SH) (3) | Grant Date Fair Value of Option Awards (\$)(4) |
|-----------------|----------------|------------------|----------------|---|--|--|
|                 |                |                  | Options (#)(2) |   |  |  |
| James E. Reeder | 1/13/11        | 1/6/11           | 100,000        | \$0.10  | \$0.09                                 | \$9,091  |

(1) The grant date of an option award is the date that the Board of Directors fixes as the date the recipient is entitled to receive the award. The approval date is the date that the Board of Directors approves the award. Our policy is to set the exercise price of options as the average market price of the Company's stock for the five trading days following the date of approval of the grant, and the actual grant date is the last day of such five day period.

(2) Option awards have a 10 year term and vests over a four-year period.

(3) The exercise price of option awards may differ from the market price on the date of grant. The exercise price of options granted in 2011 is equal to the average closing sales prices of our common stock for the five trading days prior to and including the grant date, as reported on the OTCQB, while the market price on the date of grant is the closing price of our common stock on that date.

(4) The grant date fair value is generally the amount we would expense in our financial statements over the award's service period, but does not include a reduction for forfeitures.



## Outstanding Equity Awards at Fiscal Year 2011

The following table provides information with respect to outstanding stock options and stock awards held by each of the named executive officers as of December 31, 2011.

| Name                 | Grant Date | Option Awards      |                      |                                  |                              | RSU Stock Awards   |   |
|----------------------|------------|--------------------|----------------------|----------------------------------|------------------------------|--|---|
|                      |            | (#)<br>Exercisable | (#)<br>Unexercisable | Option<br>Exercise<br>Price (\$) | Option<br>Expiration<br>Date | Number of<br>Shares or<br>Units of<br>Stock That<br>Have Not<br>Vested<br>(#)(2) | Market<br>Value of<br>Shares or<br>Units of<br>Stock<br>That Have<br>Not<br>Vested<br>(\$)(3) |
| Lonnie D.<br>Schnell | 6/25/08    | 900,000            | -                    | \$ 0.20                          | 06/24/18                     |  |   |
|                      | 8/6/09     | 700,000            | -                    | \$ 0.09                          | 8/6/19                       |  |   |
|                      | 7/30/10    |                    |                      |                                  |                              | 2,889,250  | 317,818   |
| Larry Dyne           | 6/25/08    | 700,000            | -                    | \$ 0.20                          | 06/24/18                     |  |   |
|                      | 8/6/09     | 510,000            | -                    | \$ 0.09                          | 8/6/19                       |  |   |
|                      | 7/30/10    |                    |                      |                                  |                              | 2,889,250  | 317,818   |
| James E.<br>Reeder   | 6/1/09     | 125,000            | 75,000 (1)           | \$ 0.11                          | 6/1/19                       |  |   |
|                      | 1/13/11    | -                  | 100,000 (1)          | \$ 0.10                          | 1/13/21                      |  |   |

(1) These options vest and become exercisable with respect to 25% of the total options shares at the end of one year from the date of the grant and the remaining shares shall become exercisable in 36 monthly installments equal to 1/48th of the Option shares on the last day of each calendar month thereafter until fully exercisable.

(2) Each RSU original award of 5,778,500 vests 50% on a date which is 13 months following the grant date, and 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to partial acceleration of vesting as part of the executives' severance benefits and full acceleration of vesting upon a change in control of the Company, as defined in the RSU Award agreement. Issuance of the common shares upon settlement of the vested portion of the RSU Award is subject to irrevocable deferral elections delivered by the recipients.

(3) Based on the closing price of the Common Stock on December 31, 2011 of \$0.11, as reported by the OTCQB.

## Options Exercises and Stock Vested in Fiscal Year 2011

The following table provides information with respect restricted stock award vesting for each of the named executive officers during 2011. There were no options exercised by named executive officers during 2011.

| Name | Stock Awards |                      |
|------|--------------|----------------------|
|      | Number of    | Value<br>Realized on |
|      |              |                      |

|                   | Shares<br>Acquired on<br>Vesting<br>(#)(1) | Vesting<br>(\$)(1)(2) |
|-------------------|--|-----------------------|
| Lonnie D. Schnell | 2,889,250                                  | \$ 288,925            |
| Larry Dyne        | 2,889,250                                  | \$ 288,925            |

(1) The shares shown in the table above indicate shares that vested under the RSU Awards on August 30, 2011. Pursuant to deferral elections made by both Mr. Schnell and Mr. Dyne, each of them elected to defer receipt of the common shares to be issued upon settlement of these vested RSU Awards as follows: 300,000 shares on August 30, 2011; 172,150 shares on July 30, 2012; 172,150 shares on Jan. 30, 2013; 422,150 shares on July 30, 2013; 422,150 shares on Jan. 30, 2014 and 1,400,650 shares on July 30, 2014, in each case subject to earlier settlement in the event of a change of control or the death of the reporting person.

(2) Based on the closing price of the Common Stock on August 20, 2011 of \$0.10, as reported by the OTCQB

## Employment Agreements, Termination of Employment and Change of Control Arrangements

### Employment Agreements

We have entered into the following employment agreements with Lonnie D. Schnell and Larry Dyne. Mr. Reeder does not have an employment agreement.

Lonnie D. Schnell, Chief Executive Officer and Chief Financial Officer. In connection with the Recapitalization Agreement, on July 30, 2010, we entered into an Executive Employment Agreement with Mr. Schnell. Mr. Schnell's employment agreement provides that he will continue to serve as our Chief Executive Officer. The employment agreement has a term continuing through December 31, 2013, and may be extended to December 31, 2014. Pursuant to this agreement, Mr. Schnell received an annual base salary of \$325,000 for the period starting on July 30, 2010 through December 31, 2010. Starting on January 1, 2011 through the remainder of the term of this agreement, Mr. Schnell's annual base salary will be \$350,000. Such base salary may be increased, but not decreased, at the discretion of the Board. Mr. Schnell will be entitled to receive an annual cash bonus in an amount equal to a percentage of his base salary upon Talon achieving actual adjusted EBITDA within a range, starting at 80%, of target adjusted EBITDA.

Mr. Schnell is entitled to an auto allowance of \$1,000 per month, and reimbursement of up to \$10,000 for legal fees incurred in connection with the negotiation of his employment agreement. In the event that prior to the end of the term, Mr. Schnell's employment is terminated by us "without cause" (as defined in the agreement), by Mr. Schnell for "good reason" (as defined in the agreement) or due to Mr. Schnell's death or disability, then conditional upon his execution of a release of claims, Mr. Schnell or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to 18 months of Mr. Schnell's base salary (ii) all options issued to Mr. Schnell shall remain outstanding for 18 months following termination, and (iii) continued medical coverage for Mr. Schnell and his dependents for 18 months following termination.

Larry Dyne, President. In connection with the Recapitalization Agreement, on July 30, 2010, we entered into an Executive Employment Agreement with Mr. Dyne. Mr. Dyne's employment agreement provides that he will continue to serve as our President. The employment agreement has a term continuing through December 31, 2013, and may be extended to December 31, 2014. Pursuant to this agreement, Mr. Dyne received an annual base salary of \$300,000 for the period starting on July 30, 2010 through December 31, 2010. Starting on January 1, 2011 through the remainder of the term of this agreement, Mr. Dyne's annual base salary will be \$325,000. Such base salary may be increased, but not decreased, at the discretion of the Board. Mr. Dyne will be entitled to receive an annual cash bonus in an amount equal to a percentage of his base salary upon Talon achieving actual adjusted EBITDA within a range, starting at 80%, of target adjusted EBITDA.

Mr. Dyne is entitled to an auto allowance of \$950 per month, and reimbursement of up to \$10,000 for legal fees incurred in connection with the negotiation of his employment agreement. In the event that prior to the end of the term, Mr. Dyne's employment is terminated by us "without cause" (as defined in the agreement), by Mr. Dyne for "good reason" (as defined in the agreement) or due to Mr. Dyne's death or disability, then conditional upon his execution of a release of claims, Mr. Dyne or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to 18 months of Mr. Dyne's base salary, (ii) all options issued to Mr. Dyne shall remain outstanding for 18 months following termination, and (iii) continued medical coverage for Mr. Dyne and his dependents for 18 months following termination.

### Potential Severance Payments

Under the Executive Employment Agreements described above, Messrs. Schnell and Dyne will be entitled to receive severance benefits in the event that the executive's employment is terminated due to executive's death or disability, by us without "cause" or by the executive for "good reason." The following table sets forth severance payments and benefits that we would have been obligated to pay to Messrs. Schnell and Dyne assuming a triggering event had occurred under each of their respective employment agreements as of December 31, 2011 as follows:

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| Name              | Cash<br>Severance<br>Payment<br>(\$)(1) | Bonus (\$) | Continuation<br>of Health<br>Benefits (\$) | Total<br>Severance<br>Benefits<br>(\$) |
|-------------------|---|------------|--|--|
| Lonnie D. Schnell | 587,622                                 | 70,000     | 38,587                                     | 696,209                                |
| Larry Dyne        | 544,550                                 | 65,000     | 19,910                                     | 629,460                                |

(1) Includes (a) earned and unpaid base salary through the date of termination, (b) accrued but unpaid vacation and (c) severance payments equal to 18 months of base salary and payable in a lump sum or periodic payments as provided in the executive's employment agreement and (d) car allowance payments due at the first day of the month during the severance period (18 months) as provided in the executive's employment agreement.

#### Potential Change in Control Payments

Each RSU Award to Messrs. Schnell and Dyne will vest 100% upon a change in control of our Company, as defined in the RSU Award agreement. In addition, in accordance with their deferral elections, the entire vested portion of the RSU Award subject to a deferral will be immediately settled in common shares upon a change in control transaction. The following table sets forth the change in control benefits that we would have been obligated to pay to our named executive officers assuming a change of control had occurred as of December 31, 2011.

| Name              | Value of<br>Acceleration<br>of<br>Vesting of<br>Equity<br>Awards<br>(\$)(1) |
|-------------------|---|
| Lonnie D. Schnell | 317,818   |
| Larry Dyne        | 317,818   |

(1) Based on the closing price of the Common Stock on December 31, 2011 of \$0.11, as reported by the OTCQB.

#### Director Compensation

The general policy of the Board of Directors is that compensation for independent directors should be a mix of cash and equity-based compensation. We do not pay management directors for Board service in addition to their regular employee compensation. The full Board of Directors has the primary responsibility for reviewing and considering any revisions to director compensation.

The following table details the total compensation earned by our non-employee directors in 2011.

| Name                       | Fees earned or<br>paid in cash | Option<br>awards (3) | Total      |
|----------------------------|--------------------------------|----------------------|------------|
| Mark Dyne (1)              | \$ 20,000                      | \$ 8,918             | \$ 28,918  |
| David Ellis (2)            | 14,500                         | 8,918                | 23,418     |
| Mark J. Hughes (2)         | 15,500                         | 8,918                | 24,418     |
| Michael Francis Snyder (2) | 15,500                         | 8,918                | 24,418     |
| Total                      | \$ 65,500                      | \$ 35,672            | \$ 101,172 |

- (1) As of December 31, 2011, Mr. Mark Dyne held options to purchase a total of 240,000 shares.
- (2) As of December 31, 2011, each of the Messrs. Ellis, Hughes and Snyder held options to purchase a total of 100,000 shares.
- (3) The grant date fair value is generally the amount we would expense in our financial statements over the award's service period, but does not include a reduction for forfeitures.

Our current policy, adopted as of January 1, 2011, is to pay non-employee directors \$1,000 for their personal attendance at any meeting of the Board of Directors and \$500 for attendance at any telephonic meeting of the Board of Directors. We will also pay non-employee directors an annual retainer of \$10,000 for Board service. The Chairman of the Board will receive an annual retainer of \$15,000 for Board service. Our Board of Directors does not have standing audit, compensation or nominating committees. The Board of Directors handles all audit, compensation and nominating committee matters. We also reimburse directors for their reasonable travel expenses incurred in attending board meetings.

In addition, our current policy is to annually grant to each non-employee director an option to purchase 100,000 shares of our common stock, which will vest in 12 equal monthly installments. On January 13, 2011, we issued 100,000 options to each of the Messrs. Mark Dyne, David Ellis, Mark J. Hughes and Michael Francis Snyder, which become exercisable in 12 equal monthly installments, and was fully vested one year from the date of grant.

#### Risk Assessment Regarding Compensation Policies and Practices

Our compensation program for employees does not create incentives for excessive risk taking by our employees or involve risks that are reasonably likely to have a material adverse effect on Talon. Our base salary component of compensation does not encourage risk-taking because it is a fixed amount. Our executive bonus plan for senior executives and our equity compensation awards have the following risk-limiting characteristics:

- Cash awards to each executive officer under management incentive bonus plans are set in a market range and are limited by the terms of the plan for senior executives to a fixed maximum specified in the plan;
- Equity and discretionary cash awards are made based on a review of a variety of indicators of performance, thus diversifying the risk associated with any single indicator of performance;
- Neither cash nor equity awards are not tied to formulas that could focus executives on specific short-term outcomes;
- Members of the Board of Directors approve the final cash incentive awards made under the executive bonus plan for senior executives in their discretion, after the review of executive and corporate performance;
  - Members of the Board of Directors approve all equity awards for senior executives in their discretion; and
- An equity award's value is delivered in the form of stock and options that vest over multiple years, which aligns the interests of executive officers to long-term stockholder interests.

#### Compensation Committee Interlocks and Insider Participation

The Board of Directors currently performs the function of a compensation committee. None of our current executive officers has served as a member of the board of directors or compensation committee of any entity for which a member of our Board of Directors has served as an executive officer.

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

Equity Compensation Plan Information

The following table sets forth certain information as of December 31, 2011 regarding equity compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance:

| Name   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans |
|--|---|--|--|
| Equity compensation plans approved by security holders     | 6,142,100   | \$0.22   | 1,400,625  |
| Equity compensation plans not approved by security holders | 10,957,000  | -  | -  |

Equity compensation plans not approved by security holders consist of restricted stock units awarded to certain executives in 2010. Upon entering into employment agreements on July 30, 2010, each of Lonnie Schnell and Larry Dyne were granted a restricted stock unit award for 5,778,500 shares of our common stock. Each RSU Award vested 50% on the date that was 13 months following the grant date, and vests an additional 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to full acceleration of vesting upon a change in control of our Company, as defined in the RSU Award agreement. On August 30, 2010, Messrs. Schnell and Dyne elected to defer the settlement in common shares of 5,178,500 total units vested under the RSU Awards beyond the vesting dates. On August 30, 2011, based on the deferral schedules, 600,000 common shares were issued in settlement of a portion of the vested units under the RSU Awards. On January 30, 2012, based on the deferral schedules, an additional 900,000 common shares were issued in settlement of a portion of the vested units under the RSU Awards.

Each of the above plans provides that the number of shares with respect to which options and warrants may be granted, and the number of shares of common stock subject to an outstanding option or warrant, shall be proportionately adjusted in the event of a subdivision or consolidation of shares or the payment of a stock dividend on common stock.

Security Ownership of Certain Beneficial Owners and Management

The following table presents information regarding the beneficial ownership of our common stock as of March 26, 2012:

- each person who is known to us to be the beneficial owner of more than 5% of our outstanding common Stock;
- each of our current directors;
- each of our named executive officers; and
- all of our directors and executive officers as a group.



Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission that deem shares to be beneficially owned by any person who has or shares voting or investment power with respect to such shares. Each share of our Series B Preferred Stock is convertible into one hundred shares of our Common Stock at the discretion of the holder. Accordingly, a holder of one share of our Series B Preferred Stock is deemed to be the beneficial owner of one hundred shares of our Common Stock for purposes of the table below. Shares of Common Stock underlying warrants or options currently exercisable or exercisable within sixty (60) days of the date of this information are deemed outstanding for purposes of computing the percentage ownership of the person holding such warrants or options but are not deemed outstanding for computing the percentage ownership of any other person. As a result, the percentage of outstanding shares of any person as shown in this table does not necessarily reflect the person's actual ownership or voting power with respect to the number of shares of Common Stock actually outstanding at March 26, 2012. Unless otherwise indicated, the persons named in this table have sole voting and sole investment power with respect to all shares shown as beneficially owned, subject to community property laws where applicable.

As of March 26, 2012, we had 21,900,808 shares of Common Stock and 407,160 shares of Series B Preferred Stock issued and outstanding. The address of each person listed is in our care, at 21900 Burbank Boulevard, Suite 270, Woodland Hills, California 91367, unless otherwise set forth below such person's name.

| Name of Beneficial Owner  | Common Stock |      | Series B Preferred Stock |     | % of Total Voting Power |
|---|--------------|------|--------------------------|-----|-------------------------|
|   | Shares       | %    | Shares                   | %   |                         |
| <b>Executive Officers and Directors:</b>  |              |      |                          |     |                         |
| Lonnie D. Schnell (1)   | 2,475,000    | 10.5 | --                       | --  | 3.9                     |
| Larry Dyne (2)  | 2,089,600    | 9.0  | --                       | --  | 3.3                     |
| Mark Dyne (3)   | 1,075,667    | 4.9  | --                       | --  | 1.7                     |
| James E. Reeder (4)   | 256,250      | 1.2  | --                       | --  | *                       |
| Mark J. Hughes (5)  | 100,000      | *    | --                       | --  | *                       |
| David Ellis (5)   | 100,000      | *    | --                       | --  | *                       |
| Michael Francis Snyder (5)  | 100,000      | *    | --                       | --  | *                       |
| Executive Officers and Directors as a Group (7 persons) (6)                                   | 6,196,517    | 24.4 | --                       | --  | 9.4                     |
| <b>5% Stockholders:</b>   |              |      |                          |     |                         |
| CVC California, LLC (7)<br>525 Okeechobee Blvd., Suite 1050<br>West Palm Beach, Florida 33401 | 1,750,000    | 8.0  | 407,160                  | 100 | 67.8                    |

\*Less than 1%.

- (1) Consists of (i) 875,000 shares of Common Stock and (ii) 1,600,000 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable.
- (2) Consists of (i) 879,600 shares of Common Stock and (ii) 1,210,000 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable.
- (3) Consists of (i) 835,667 shares of Common Stock and (ii) 240,000 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable or will become exercisable within 60 days.
- (4) Consists of (i) 75,000 shares of Common Stock and (ii) 181,250 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable or will become exercisable within 60 days.
- (5) Includes 100,000 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable or will become exercisable within 60 days.

(6) Consists of (i) 2,665,267 shares of Common Stock and (ii) 3,531,250 shares of Common Stock reserved for issuance upon exercise of stock options that are currently exercisable or will become exercisable within 60 days.

(7) Consists of (i) 1,750,000 shares of Common Stock, and (ii) 407,160 shares of Series B Preferred Stock, convertible into 40,716,000 shares of Common Stock. Excludes shares of Common Stock beneficially owned by Lonnie D. Schnell and Larry Dyne, which shares are the subject of a limited voting agreement with this stockholder and with respect to which this stockholder has been granted a limited proxy to vote such shares, in each case with respect to certain fundamental transaction involving the Company.

The information as to shares beneficially owned has been individually furnished by our respective directors, named executive officers, and our other stockholders, or taken from documents filed with the Securities and Exchange Commission.

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

#### Review and Approval of Related Party Transactions

We have adopted a policy that requires Board of Directors approval of transactions with related persons as defined by SEC regulations, including any sales or purchase transaction, asset exchange transaction, operating agreement, or advance or receivable transaction that could put our assets or operating performance at risk. All of our directors and executive officers are required at all times, but not less than annually, to disclose all relationships they have with companies or individuals that have conducted business with, or had an interest in, us. Our executive officers monitor our operations giving consideration to the disclosed relationships and refer potential transactions to the Board of Directors for approval. The Board of Directors considers a related party transaction for its potential economic benefit to us, to ensure the transaction is “arms length” and in accordance with our policies and that it is properly disclosed in our reports to shareholders.

#### Reportable Related Party Transactions

Other than the employment arrangements described elsewhere in this report and the transactions described below, since January 1, 2011, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which we were or will be a party:

- in which the amount involved exceeds \$120,000; and
- in which any director, executive officer, shareholder who beneficially owns 5% or more of our common stock or any member of their immediate family had or will have a direct or indirect material interest.

Notes payable to related parties includes a note and associated interest due to Lonnie D. Schnell, our Chief Executive Officer and Chief Financial Officer. The note was issued on August 6, 2009 in partial satisfaction of 2008 annual incentive amounts to which Mr. Schnell was entitled. The balance of the note payable and accrued interest expense due to Mr. Schnell at December 31, 2011 and 2010 was \$41,159 and \$38,768, respectively, and the balance was paid in full subsequent to the year ending December 31, 2011.

Notes payable to related parties also included demand notes and advances to parties related to or affiliated with Mark Dyne, Chairman of our Board of Directors, a stockholder and the brother of our President. The balance of demand notes payable and interest expense due to Mark Dyne and affiliated parties at December 31, 2011 and December 31, 2010 was \$198,783 and \$236,448, respectively. On August 2, 2011 the Promissory Note dated as of June 30, 1991 in favor of Harold Dyne was paid in full, including accrued interest, in the aggregate amount of \$44,340. Subsequent to the year ending December 31, 2011 the note in favor of Monto Holdings Pty, Ltd was paid in full, including accrued interest, in the aggregate amount of \$199,798.



In March 2010, a consulting agreement with Diversified Consulting, LLC, a company owned by Mark Dyne expired. Accrued consulting fees and related interest amounted to \$0 and \$164,761, as of December 31, 2011 and 2010, respectively, in consideration of the final payments under the agreement. Consulting fees and related interest to Diversified Consulting, LLC amounted to \$6,464, \$63,194 and \$401,568 for the years ended December 31, 2011, 2010, and 2009, respectively. On August 4, 2011 the balance of \$83,725 due under this agreement was paid in full to Diversified Consulting, LLC.

Colin Dyne is a director, officer and significant stockholder of People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. and William Rast Sourcing ("PLI"). Also, Colin Dyne is the brother of both Mark Dyne, our Chairman of the board of directors and Larry Dyne, our President. We had sales to PLI during the years ended December 31, 2011, 2010 and 2009 of \$142,530, \$120,270 and \$207,322, respectively. Accounts receivable of \$3,112 and \$26,739 were outstanding from PLI at December 31, 2011 and 2010, respectively.

In November 2009, we entered into an agreement with Colin Dyne to pay a commission equal to 7% of the collected revenues associated with the sales of products to a specific retail brand, with a portion of the commission earned applied to a then outstanding note receivable balance. During the years ended December 31, 2011, 2010 and 2009 commissions of \$72,640, \$172,506 and \$13,269 were earned under this agreement, respectively, and for the year ended December 31, 2010 commissions of \$27,057 were applied to the note receivable balance.. The Note Receivable from Related Party, net at December 31, 2009 represented the unsecured note and accrued interest receivable due from Colin Dyne, and included a valuation reserve for the full amount due. The note bore interest at 7.5% and was due on demand. On June 29, 2010, we sold the Note Receivable with all of our rights, title and interest therein to an unrelated third party for cash proceeds of \$275,000. The amount received was recorded as a recovery of bad debts.

#### Director Independence

Because our common stock is quoted on the OTCQB, we are not subject to the listing requirements of any securities exchange or Nasdaq regarding the independence of our directors. However, we have determined that, as of December 31, 2011, each of Messrs. Ellis and Snyder is "independent" as that term is defined in Section 5605 of the NASDAQ Marketplace Rules applicable to companies listed on The NASDAQ Stock Market. The other members of our Board of Directors are not "independent" under such rules.

#### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

##### Services Provided by the Independent Auditors

Our Board of Directors performed the functions of the audit committee and is responsible for the appointment, compensation, retention and oversight of the work of the independent auditors.

SingerLewak LLP served as our independent registered public accounting firm for each of the fiscal years ended December 31, 2011, 2010 and 2009.

**Audit Fees** - The aggregate fees billed by our independent registered public accounting firm for professional services rendered for the audit of our annual financial statements and review of our financial statements included in our Forms 10-Q or services that are normally provided in connection with statutory and regulatory filings were \$326,000 for fiscal year 2011, \$310,000 for fiscal year 2010 and \$370,000 for fiscal year 2009.

**Audit-Related Fees** - No fees billed by our independent registered public accounting firm for professional services rendered for assurance and related services reasonably related to the performance of the audit or review of our financial statements (other than those reported above) for fiscal years 2011, 2010 and 2009.

**Tax Fees** - The aggregate fees billed by our independent registered public accounting firm for professional services rendered for tax compliance, tax advice and tax planning were \$31,000 for fiscal year 2011, \$59,000 for fiscal year 2010 and \$37,000 for fiscal year 2009.

**All Other Fees** – The aggregate fees billed by our independent public registered accounting firm for services rendered to us other than the services described above under “Audit Fees,” “Audit-Related Fees” and “Tax Fees” were \$0 for fiscal year 2011, \$24,000 for fiscal year 2010 and \$5,000 for fiscal year 2009 which was primarily related governmental regulations not related to our annual or quarterly financial statements.

The Board of Directors approved all of the foregoing services provided by SingerLewak LLP.

#### Policy Regarding Pre-Approval of Services Provided by the Independent Auditors

The Board of Directors has established a general policy requiring its pre-approval of all audit services and permissible non-audit services provided by the independent auditors, along with the associated fees for those services. For both types of pre-approval, the Board of Directors considers whether the provision of a non-audit service is consistent with the SEC’s rules on auditor independence, including whether provision of the service (1) would create a mutual or conflicting interest between the independent auditors and us, (2) would place the independent auditors in the position of auditing its own work, (3) would result in the independent auditors acting in the role of management or as our employee, or (4) would place the independent auditors in a position of acting as an advocate for us. Additionally, the Board of Directors considers whether the independent auditors are best positioned and qualified to provide the most effective and efficient service, based on factors such as the independent auditors’ familiarity with our business, personnel, systems or risk profile and whether provision of the service by the independent auditors would enhance our ability to manage or control risk or improve audit quality or would otherwise be beneficial to us.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULE

(a) List the following documents filed as a part of this report:

(1) Financial Statements

See Index to Financial Statements in Item 8 of this Annual Report on Form 10-K, which is incorporated herein by reference.

(2) Financial Statement Schedule

Schedule II – Valuation and Qualifying Accounts Reserves is included beginning on the following page.

(3) Exhibits

See Exhibit Index attached to this Annual Report on Form 10-K, which is incorporated herein by reference.

## Schedule II – Valuation and Qualifying Accounts and Reserves

| Description  | Balance at<br>Beginning of<br>Year | Additions<br>(Adjustments) | Deductions    | Balance at End<br>of Year |
|--|------------------------------------|----------------------------|---------------|---------------------------|
| <b>2011</b>  |                                    |                            |               |                           |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 133,000                         | \$ 32,000                  | \$ 112,000    | \$ 53,000                 |
| Reserve for inventory valuation deducted from inventories on the balance sheet         | 884,000                            | (36,000 )                  | 363,000       | 485,000                   |
| Valuation reserve deducted from Deferred tax assets                                    | 9,397,000                          | 541,000                    | 744,000       | 9,194,000                 |
|  | \$ 10,414,000                      | \$ 537,000                 | \$ 1,219,000  | \$ 9,732,000              |
| <b>2010</b>  |                                    |                            |               |                           |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 232,000                         | \$ (76,000 )               | \$ 23,000     | \$ 133,000                |
| Allowance for doubtful accounts deducted from related party in the balance sheet       | 674,000                            | (275,000 )                 | 399,000       | -                         |
| Reserve for inventory valuation deducted from inventories on the balance sheet         | 1,185,000                          | 106,000                    | 407,000       | 884,000                   |
| Valuation reserve deducted from Deferred tax assets                                    | 24,145,000                         | 1,088,000                  | 15,836,000    | 9,397,000                 |
|  | \$ 26,236,000                      | \$ 843,000                 | \$ 16,665,000 | \$ 10,414,000             |
| <b>2009</b>  |                                    |                            |               |                           |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 217,000                         | \$ 122,000                 | \$ 107,000    | \$ 232,000                |
| Allowance for doubtful accounts deducted from related party in the balance sheet       | 474,000                            | 200,000                    | -             | 674,000                   |
| Reserve for inventory valuation deducted from inventories on the balance sheet         | 1,211,000                          | 61,000                     | 87,000        | 1,185,000                 |
| Valuation reserve deducted from Deferred tax assets                                    | 23,469,000                         | 676,000                    | -             | 24,145,000                |
|  | \$ 25,371,000                      | \$ 1,059,000               | \$ 194,000    | \$ 26,236,000             |

(1) Additions to the allowance for doubtful accounts include provisions for uncollectible accounts. Bad debt expense includes (and additions above exclude) net direct write-offs of approximately \$4,000, \$18,000 and \$(2,000) for the years ended December 31, 2011, 2010 and 2009, respectively. Additions to the inventory valuation reserve include current year provisions. Additionally, in 2011, 2010 and 2009 there were direct write-offs of \$243,000, \$364,000 and \$223,000, respectively.

(2) Deductions from the allowance for doubtful accounts include amounts applied to write-offs and reversals of prior period provisions. Deductions from the inventory valuation reserve include application of the reserve against obsolete, excess, slow-moving or disposed inventory.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TALON INTERNATIONAL, INC.

/s/ Lonnie D. Schnell

By: Lonnie D. Schnell  
Its: Chief Executive Officer & Chief  
Financial Officer  
(Principal Executive Officer & Principal Financial  
Officer)

/s/ James E. Reeder

By: James E. Reeder  
Its: Vice President, Corporate Controller  
(Principal Accounting Officer)

## POWER OF ATTORNEY

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

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature  | Title  | Date              |
|--|--|-------------------|
| /s/ Lonnie D. Schnell<br>Lonnie D. Schnell           | Chief Executive Officer and Chief Financial Officer, Director<br>(Principal Executive and Financial Officer) | March 26,<br>2012 |
| /s/ James E. Reeder<br>James E. Reeder               | Vice President, Corporate Controller (Principal Accounting<br>Officer)                                       | March 26,<br>2012 |
| /s/ Mark Dyne<br>Mark Dyne                           | Chairman of the Board of Directors   | March 26,<br>2012 |
| /s/ David Ellis<br>David Ellis                       | Director   | March 26,<br>2012 |
| /s/ Mark J. Hughes<br>Mark J. Hughes                 | Director   | March 26,<br>2012 |
| /s/ Michael Francis Snyder<br>Michael Francis Snyder | Director   | March 26,<br>2012 |

## EXHIBIT INDEX

| Exhibit Number | Exhibit Description   |
|----------------|---|
| 3.1            | Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.  |
| 3.1.2          | Certificate of Designation of Rights, Preferences and Privileges of Series A Preferred Stock. Incorporated by reference to Exhibit A to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. |
| 3.1.3          | Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.4 to Annual Report on Form 10-KSB, filed March 28, 2000.   |
| 3.1.4          | Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1.3 to Form 8-K filed on August 4, 2006.   |
| 3.1.5          | Certificate of Ownership and Merger. Incorporated by reference to Exhibit 3.1 to Form 8-K filed on July 20, 2007.   |
| 3.1.6          | Certificate of Designation of Series B Convertible Preferred Stock. Incorporated by reference to Exhibit 3.1 to Form 8-K filed on August 5, 2010.   |
| 3.1.7          | Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1 to Form 8-K filed on November 24, 2010.  |
| 3.2.1          | Bylaws of Registrant. Incorporated by reference to Exhibit 3.2 to Form SB-2 filed on October 21, 1997, and the amendments thereto.  |
| 3.2.2          | Certificate of Amendment to the Bylaws of Talon International, Inc., dated as of August 2, 2011. Incorporated by reference to Exhibit 3.2 to Form 8-K filed on August 4, 2011.  |
| 4.1            | Specimen Stock Certificate of Common Stock of Registrant. Incorporated by reference to Exhibit 4.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.  |
| 4.2            | Rights Agreement, dated as of November 4, 1998, between Registrant and American Stock Transfer and Trust Company as Rights Agent. Incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998.        |
| 4.3            | Form of Rights Certificate. Incorporated by reference to Exhibit B to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998.   |
| 10.1           | Form of Indemnification Agreement. Incorporated by reference to Exhibit 10.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto.  |

| Exhibit Number | Exhibit Description   |
|----------------|---|
| 10.2 (2)       | Amended and Restated 1997 Stock Incentive Plan. Incorporated by reference to Exhibit 10.7 to Form 10-Q filed on November 13, 2006.  |
| 10.3 (2)       | Form of Non-statutory Stock Option Agreement. Incorporated by reference to Exhibit 10.30 to Form SB-2 filed on October 21, 1997, and the amendments thereto.  |
| 10.4           | Form of Investor Rights Agreements dated December 28, 2001. Incorporated by reference to Exhibit 99.4 to Form 8-K filed on January 23, 2002.  |
| 10.5 (1)       | Intellectual Property Rights Agreement, dated April 2, 2002, between the Company and Pro-Fit Holdings, Ltd. Incorporated by reference to Exhibit 10.69 to Form 10-K/A filed on October 1, 2003.   |
| 10.6 (2)       | 2007 Stock Plan. Incorporated by reference to Exhibit 10.20 to the Form 10-K filed on April 25, 2008.   |
| 10.7           | Revolving Credit and Term Loan Agreement dated June 27, 2007, by and between Tag-It Pacific, Inc. and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.35 to Form 10-Q filed on August 14, 2007.   |
| 10.7.1         | Amendment No. 1 to Loan Agreement dated July 30, 2007, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.20 to the Form 10-K filed on April 25, 2008.   |
| 10.7.2         | Amendment No. 2 to Loan Agreement dated November 19, 2007, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.35.2 to Form 8-K filed on November 26, 2007.   |
| 10.7.3         | Amendment No. 3 to Loan Agreement dated as of March 31, 2008, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.21.3 to Form 10-Q filed on May 15, 2008.  |
| 10.7.4         | Amendment No. 4 to Loan Agreement dated as of March 31, 2009, by and between the Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.19.4 to Form 10-Q filed on May 15, 2009.   |
| 10.7.5         | Amendment No. 5 to Loan Agreement, dated June 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.2 to Form 8-K filed on August 5, 2010.  |
| 10.7.6         | Amendment No. 6 to Loan Agreement, dated July 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.3 to Form 8-K filed on August 5, 2010.  |
| 10.8           | Guaranty Agreement, dated June 27, 2007, by Talon International, Inc., Tag-It, Inc., A.G.S. Stationary, Inc., Tag-It Pacific Limited, Tag-It Pacific (HK) Ltd., Tagit de Mexico, S.A. de C. V., Talon Zipper (Shenzhen) Company, Ltd., and Talon International, Pvt. Ltd. in favor of Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.36 to Form 10-Q filed on August 14, 2007. |

| Exhibit Number | Exhibit Description   |
|----------------|---|
| 10.9           | Collateral Agreement, dated June 27, 2007, by and among Tag-It Pacific, Inc., Talon International, Inc., Tag-It, Inc., A.G.S. Stationary, Inc., Tag-It Pacific Limited, Tag-It Pacific (HK) Ltd., Tagit de Mexico, S.A. de C. V., Talon Zipper (Shenzhen) Company, Ltd., and Talon International, Pvt. Ltd. in favor of Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.37 to Form 10-Q filed on August 14, 2007. |
| 10.10          | Registration Rights Agreement, dated June 27, 2007, by Talon International, Inc., for the benefit of holders. Incorporated by reference to Exhibit 4.10 to Registration Statement on Form S-3 filed on August 10, 2007.   |
| 10.11 (2)      | Amended and Restated Talon International, Inc. 2008 Stock Incentive Plan. Incorporated by reference to Exhibit 10.20 to Form 10-K filed on March 28, 2011.  |
| 10.12 (2)      | Sales and Service Representative Agreement, dated November 13, 2009, between Talon International, Inc. and The Link Trading LLC. Incorporated by reference to Exhibit 10.28 to Form 10-Q filed on November 13, 2009.  |
| 10.13          | Recapitalization Agreement, dated June 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on August 5, 2010.   |
| 10.14          | Amended and Restated Revolving Credit Note, dated July 30, 2010, made by Registrant in favor of CVC California, LLC. Incorporated by reference to Exhibit 10.4 to Form 8-K filed on August 5, 2010.   |
| 10.15          | Stockholders Agreement, dated July 30, 2010, among Registration, CVC California, LLC, Lonnie D. Schnell and Larry Dyne. Incorporated by reference to Exhibit 10.5 to Form 8-K filed on August 5, 2010.  |
| 10.16 (2)      | Employment Agreement, dated July 30, 2010, between Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.25 to Form 10-Q filed on August 8, 2011.   |
| 10.17 (2)      | Employment Agreement, dated July 30, 2010, between Registrant and Larry Dyne. Incorporated by reference to Exhibit 10.26 to Form 10-Q filed on August 8, 2011.  |
| 10.18 (2)      | Restricted Stock Unit Agreement, dated July 30, 2010, between Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.8 to Form 8-K filed on August 5, 2010.  |
| 10.19 (2)      | Restricted Stock Unit Agreement, dated July 30, 2010, between Registrant and Larry Dyne. Incorporated by reference to Exhibit 10.9 to Form 8-K filed on August 5, 2010.   |
| 14.1           | Code of Ethics. Incorporated by reference to Exhibit 14.1 to Form 10-K filed on March 30, 2004.   |
| 21.1           | Subsidiaries.   |
| 23.1           | Consent of SingerLewak LLP.   |
| 24.1           | Power of Attorney (included on signature page).   |

| Exhibit Number | Exhibit Description  |
|----------------|--|
| 31.1           | Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended. |
| 32.1           | Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended. |
| 101.INS(3)     | XBRL Instance  |
| 101.SCH(3)     | XBRL Taxonomy Extension Schema   |
| 101.CAL(3)     | XBRL Taxonomy Extension Calculation  |
| 101.DEF(3)     | XBRL Taxonomy Extension Definition   |
| 101.LAB(3)     | XBRL Taxonomy Extension Labels   |
| 101.PRE(3)     | XBRL Taxonomy Extension Presentation   |

(1) Certain portions of this agreement have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for an order granting confidential treatment pursuant to Rule 24b-2 of the General Rules and Regulations under the Securities Act of 1933, as amended.

(2) Indicates a management contract or compensatory plan.

(3) XBRL information is furnished and not filed or a part of a registration statement or prospectus for purpose of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.