

TALON INTERNATIONAL, INC.  
Form 10-Q  
August 11, 2011  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended June 30, 2011.

OR

☐ 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 Issuer as Specified in its Charter)

Delaware  
(State or Other Jurisdiction  
of  
Incorporation or  
Organization)

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

21900 Burbank Boulevard, Suite 270  
Woodland Hills, California 91367  
(Address of Principal Executive Offices)

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

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

Indicate by check mark whether the registrant 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 (§232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☒

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

At August 10, 2011, the issuer had 20,400,808 shares of Common Stock, \$.001 par value, issued and outstanding.

TALON INTERNATIONAL, INC.

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## TALON INTERNATIONAL, INC.

## CONSOLIDATED BALANCE SHEETS

|                                                                                                                                                                             | June 30,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------|
| Assets                                                                                                                                                                      |                                 |                      |
| Current assets:                                                                                                                                                             |                                 |                      |
| Cash and cash equivalents                                                                                                                                                   | \$6,127,613                     | \$2,795,284          |
| Accounts receivable, net                                                                                                                                                    | 3,815,295                       | 3,350,935            |
| Inventories, net                                                                                                                                                            | 1,015,862                       | 1,271,991            |
| Prepaid expenses and other current assets                                                                                                                                   | 387,842                         | 331,924              |
| Total current assets                                                                                                                                                        | 11,346,612                      | 7,750,134            |
| Property and equipment, net                                                                                                                                                 | 1,315,094                       | 1,582,327            |
| Intangible assets, net                                                                                                                                                      | 4,110,751                       | 4,110,751            |
| Other assets                                                                                                                                                                | 239,047                         | 384,455              |
| Total assets                                                                                                                                                                | \$17,011,504                    | \$13,827,667         |
| Liabilities, Preferred Stock and Stockholders' Equity (Deficit)                                                                                                             |                                 |                      |
| Current liabilities:                                                                                                                                                        |                                 |                      |
| Accounts payable                                                                                                                                                            | \$7,761,746                     | \$5,231,036          |
| Accrued expenses                                                                                                                                                            | 1,574,444                       | 1,865,841            |
| Notes payable to related parties                                                                                                                                            | 279,939                         | 275,215              |
| Other notes and current portion of capital lease obligations                                                                                                                | 71,346                          | 69,608               |
| Total current liabilities                                                                                                                                                   | 9,687,475                       | 7,441,700            |
| Capital lease obligations, net of current portion                                                                                                                           | 14,109                          | 17,492               |
| Deferred income taxes                                                                                                                                                       | 710,445                         | 608,554              |
| Other liabilities                                                                                                                                                           | 773,855                         | 740,877              |
| Total liabilities                                                                                                                                                           | 11,185,884                      | 8,808,623            |
| Commitments and contingencies (Note 11)                                                                                                                                     |                                 |                      |
| Series B Convertible Preferred Stock, \$0.001 par value; 407,160 shares authorized, issued and outstanding                                                                  | 19,156,999                      | 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; 20,400,808 and 20,291,433 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively | 20,401                          | 20,291               |
| Additional paid-in capital                                                                                                                                                  | 57,548,042                      | 56,975,314           |
| Accumulated deficit                                                                                                                                                         | (70,908,918 )                   | (69,827,780 )        |
| Accumulated other comprehensive income                                                                                                                                      | 9,096                           | 30,755               |
| Total stockholders' equity (deficit)                                                                                                                                        | (13,331,379 )                   | (12,801,420 )        |
| Total liabilities, preferred stock and stockholders' equity (deficit)                                                                                                       | \$17,011,504                    | \$13,827,667         |

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

|                                                                                                | Three Months Ended June 30, |              | Six Months Ended June 30, |              |
|------------------------------------------------------------------------------------------------|-----------------------------|--------------|---------------------------|--------------|
|                                                                                                | 2011                        | 2010         | 2011                      | 2010         |
| Net sales                                                                                      | \$12,752,281                | \$14,973,072 | \$21,980,474              | \$23,208,332 |
| Cost of goods sold                                                                             | 8,688,943                   | 10,633,835   | 15,026,583                | 16,432,402   |
| Gross profit                                                                                   | 4,063,338                   | 4,339,237    | 6,953,891                 | 6,775,930    |
| Sales and marketing expenses                                                                   | 1,065,487                   | 787,531      | 1,964,047                 | 1,444,353    |
| General and administrative expenses                                                            | 1,996,713                   | 1,853,937    | 4,279,211                 | 3,809,510    |
| Total operating expenses                                                                       | 3,062,200                   | 2,641,468    | 6,243,258                 | 5,253,863    |
| Income from operations                                                                         | 1,001,138                   | 1,697,769    | 710,633                   | 1,522,067    |
| Interest expense, net                                                                          | 23,193                      | 884,821      | 41,633                    | 1,592,018    |
| Income (loss) before provision for income taxes                                                | 977,945                     | 812,948      | 669,000                   | (69,951 )    |
| Provision for income taxes                                                                     | 321,620                     | 166,272      | 413,603                   | 131,016      |
| Net income (loss)                                                                              | \$656,325                   | \$646,676    | \$255,397                 | \$(200,967 ) |
| Available to Preferred Shareholders - Series B Preferred Stock Liquidation Preference Increase | (668,268 )                  | -            | (1,336,535 )              | -            |
| Income (loss) applicable to Common Shareholders                                                | \$(11,943 )                 | \$646,676    | \$(1,081,138 )            | \$(200,967 ) |
| Per share amounts:                                                                             |                             |              |                           |              |
| Net income (loss) per share                                                                    | \$0.03                      | \$0.03       | \$0.01                    | \$(0.01 )    |
| Available to Preferred Shareholders                                                            | (0.03 )                     | -            | (0.06 )                   | -            |
| Basic and diluted net income (loss) per share applicable to Common Shareholders                | \$0.00                      | \$0.03       | \$(0.05 )                 | \$(0.01 )    |
| Weighted average number of common shares outstanding:                                          |                             |              |                           |              |
| Basic                                                                                          | 20,367,154                  | 20,291,433   | 20,329,503                | 20,291,433   |
| Diluted                                                                                        | 20,367,154                  | 20,966,187   | 20,329,503                | 20,291,433   |

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|                                                                                          | Six Months Ended June 30, |              |
|------------------------------------------------------------------------------------------|---------------------------|--------------|
|                                                                                          | 2011                      | 2010         |
| Cash flows from operating activities:                                                    |                           |              |
| Net Income (loss)                                                                        | \$255,397                 | \$(200,967 ) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                           |              |
| Depreciation and amortization                                                            | 312,924                   | 404,101      |
| Loss from disposal of equipment                                                          | 7,391                     | -            |
| Amortization of deferred financing cost and debt discounts                               | 15,000                    | 849,096      |
| Stock based compensation                                                                 | 560,808                   | 113,148      |
| Deferred income taxes, net                                                               | 213,345                   | 89,564       |
| Bad debt recovery, related party note receivable                                         | -                         | (275,000 )   |
| Bad debt recovery, other accounts receivable                                             | (720 )                    | (73,683 )    |
| Inventory valuation provisions                                                           | (42,317 )                 | 182,936      |
| Changes in operating assets and liabilities:                                             |                           |              |
| Accounts receivable                                                                      | (452,440 )                | (1,182,388 ) |
| Inventories                                                                              | 298,446                   | (37,985 )    |
| Prepaid expenses and other current assets                                                | (54,546 )                 | (15,717 )    |
| Other assets.                                                                            | 19,798                    | (56,516 )    |
| Accounts payable and accrued expenses                                                    | 2,208,028                 | 2,062,995    |
| Other liabilities                                                                        | 32,978                    | (33,335 )    |
| Net cash provided by operating activities                                                | 3,374,092                 | 1,826,249    |
| Cash flows from investing activities:                                                    |                           |              |
| Proceeds from sale of equipment                                                          | 55,000                    | -            |
| Acquisitions of property and equipment                                                   | (102,517 )                | (21,014 )    |
| Net cash used in investing activities                                                    | (47,517 )                 | (21,014 )    |
| Cash flows from financing activities:                                                    |                           |              |
| Proceeds from exercise of stock options                                                  | 12,030                    | -            |
| Payment of capital leases                                                                | (2,906 )                  | (51,636 )    |
| Net cash provided by (used in) financing activities                                      | 9,124                     | (51,636 )    |
| Net effect of foreign currency exchange translation on cash                              | (3,370 )                  | (1,433 )     |
| Net increase in cash and cash equivalents                                                | 3,332,329                 | 1,752,166    |
| Cash and cash equivalents at beginning of period                                         | 2,795,284                 | 2,264,606    |
| Cash and cash equivalents at end of period                                               | \$6,127,613               | \$4,016,772  |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

Supplemental disclosures of cash flow information:

|                                                          | Six Months Ended June 30, |              |
|----------------------------------------------------------|---------------------------|--------------|
|                                                          | 2011                      | 2010         |
| Cash received (paid) during the period for:              |                           |              |
| Interest paid                                            | \$(14,768 )               | \$(394,083 ) |
| Interest received                                        | \$2,068                   | \$27,883     |
| Income tax paid, net (principally foreign)               | \$(97,802 )               | \$(48,916 )  |
| Non-cash financing activities:                           |                           |              |
| Series B preferred stock liquidation preference increase | \$(1,336,535 )            | \$-          |
| Interest accrued on notes payable                        | \$5,985                   | \$5,917      |
| Effect of foreign currency translation on net assets     | \$(21,659 )               | \$(6,348 )   |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Presentation of Interim Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited consolidated financial statements reflect all adjustments that, in the opinion of the management of Talon International, Inc. and its consolidated subsidiaries (collectively, the “Company”), are considered necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations for such periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in the Company’s Form 10-K for the year ended December 31, 2010. The balance sheet as of December 31, 2010 has been derived from the audited financial statements as of that date but omits certain information and footnotes required for complete financial statements.

Note 2. Summary of Significant Accounting Policies

A complete description of the Company’s Significant Accounting Policies is included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, and should be read in conjunction with these unaudited consolidated financial statements. The Significant Accounting Policies noted below are only those policies that have changed materially or have supplemental information included for the periods presented here.

Allowance for Accounts Receivable Doubtful Accounts

The Company is required to make judgments as to the collectability of accounts and note receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts and that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables 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 our historical experience, for issues not yet identified. Bad debt recoveries on accounts receivable for the three and six months ended June 30, 2011 were \$11,107 and \$720, respectively. Bad debt recoveries on accounts receivable for the three and six months ended June 30, 2010 were \$331,240 and \$348,683, respectively, which included a recovery of a related party note of \$275,000, see Note 13 “Related Party Notes and Transactions”.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Fair Value Measurements

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 - Includes 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 June 30, 2011 and December 31, 2010, cash equivalents consisted of money market funds measured at fair value on a recurring basis; fair value of the Company's money market funds was approximately \$537,000 and \$1,506,000, respectively.

The Company adopted the FASB staff position that delayed the guidance on fair value measurements for non financial assets and non financial liabilities. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

Intangible Assets

Intangible assets consist of our trade name 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 are 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, and are reviewed for impairment in accordance with the provisions of ASC 360, "Property, Plant and Equipment". The exclusive license and intellectual property rights are fully amortized.

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 sheets, 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.

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TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

Classification of Expenses

Costs 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 expense.

Sales and Marketing Expenses – Sales and marketing expenses primarily include sales salaries and commissions, travel and entertainment, marketing, advertising, royalty expense, and other sales related costs. Marketing and advertising efforts are expensed as incurred.

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 and other general corporate expenses.

Interest Expense, net – Interest expense reflects the cost of borrowing and amortization of deferred financing costs and discounts. Interest expense for the three months ended June 30, 2011 and 2010 totaled \$24,687 and \$903,319, respectively. Interest expense for the six months ended June 30, 2011 and 2010 totaled \$43,701 and \$1,619,900, respectively. Interest income consists of earnings from outstanding amounts due to the Company under notes and other interest bearing receivables. The Company recorded interest income of \$1,494 and \$2,068, respectively, for the three and six months ended June 30, 2011, as compared to \$18,499 and \$27,883, respectively for the same periods in 2010.



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## 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 until the translation adjustments are realized. Included in accumulated other comprehensive income were a cumulative foreign currency translation gain of \$9,096 and \$30,755 at June 30, 2011 and December 31, 2010, respectively.

## Comprehensive income (loss)

Comprehensive income (loss) consists of net loss and unrealized gains on foreign currency translation adjustments. Comprehensive income (loss) and its components for the three and six months ended June 30, 2011 and 2010 is as follows:

|                                     | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |              |
|-------------------------------------|--------------------------------|-----------|------------------------------|--------------|
|                                     | 2011                           | 2010      | 2011                         | 2010         |
| Net income (loss)                   | \$656,325                      | \$646,676 | \$255,397                    | \$(200,967 ) |
| Other comprehensive income (loss) - |                                |           |                              |              |
| Foreign currency translation        | 18,878                         | (3,988 )  | 21,659                       | 6,348        |
| Total comprehensive income (loss)   | \$675,203                      | \$642,688 | \$277,056                    | \$(194,619 ) |

The foreign currency translation adjustment represents the net currency translation gains and losses related to our China and India subsidiaries, which have not been reflected in the net loss for the periods presented.

## Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles 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 marketable equity securities, the valuation allowance for accounts receivable, notes receivable and inventory and 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.

## Reclassifications

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



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 3. 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 the Company’s 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 the Company’s results of operations or financial condition.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## Note 4. Net income (loss) per Share

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

|                                                                | Net loss<br>(Numerator) | Shares<br>(Denominator) | Per Share<br>Amount |
|----------------------------------------------------------------|-------------------------|-------------------------|---------------------|
| Three months ended June 30, 2011:                              |                         |                         |                     |
| Basic net loss per share:                                      |                         |                         |                     |
| Net income                                                     | \$656,325               | 20,367,154              | \$0.03              |
| Series B Preferred Stock Liquidation Preference Increase       | (668,268 )              | -                       | (0.03 )             |
| Loss applicable to Common Shareholders                         | (11,943 )               | 20,367,154              | 0.00                |
| Effect of Dilutive Securities -                                |                         |                         |                     |
| Options, Preferred Stock and RSUs                              | -                       | -                       | -                   |
| Basic and diluted net loss applicable to Common Shareholders   | \$(11,943 )             | 20,367,154              | \$0.00              |
| Three months ended June 30, 2010:                              |                         |                         |                     |
| Basic net income per share -                                   |                         |                         |                     |
| Income applicable to Common Shareholders                       | \$646,676               | 20,291,433              | \$0.03              |
| Effect of Dilutive Securities -                                |                         |                         |                     |
| Options                                                        | -                       | 674,754                 | -                   |
| Basic and diluted net income applicable to Common Shareholders | \$646,676               | 20,966,187              | \$0.03              |
| Six months ended June 30, 2011:                                |                         |                         |                     |
| Basic net loss per share:                                      |                         |                         |                     |
| Net income                                                     | \$255,397               | 20,329,503              | \$0.01              |
| Series B Preferred Stock Liquidation Preference Increase       | (1,336,535 )            | -                       | (0.06 )             |
| Loss applicable to Common Shareholders                         | (1,081,138 )            | 20,329,503              | (0.05 )             |
| Effect of Dilutive Securities -                                |                         |                         |                     |
| Options, Preferred Stock and RSUs                              | -                       | -                       | -                   |
| Basic and diluted net loss applicable to Common Shareholders   | \$(1,081,138 )          | 20,329,503              | \$(0.05 )           |
| Six months ended June 30, 2010:                                |                         |                         |                     |
| Basic net loss per share -                                     |                         |                         |                     |
| Loss applicable to Common Shareholders                         | \$(200,967 )            | 20,291,433              | \$(0.01 )           |
| Effect of Dilutive Securities -                                |                         |                         |                     |
| Options                                                        | -                       | -                       | -                   |
| Basic and diluted net loss applicable to Common Shareholders   | \$(200,967 )            | 20,291,433              | \$(0.01 )           |



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Options to purchase 6,127,100 shares of common stock exercisable between \$0.06 and \$5.23 per share were outstanding for the three and six months ended June 30, 2011, but were not included in the computation of diluted net loss per share applicable to common shareholders because the effect of exercise or conversion would have an antidilutive effect on net loss per share.

Options to purchase 6,423,600 shares of common stock exercisable between \$0.06 and \$5.23 per share were outstanding for the three and six months ended June 30, 2010. In the computation of diluted net income per share applicable to Common Shareholders, options to purchase 1,955,000 shares of common stock exercisable between \$0.06 and \$0.11 were included for the three months ended June 30, 2010. For the three and six months ended June 30, 2010 options to purchase 4,468,600 and 6,423,600 shares of common stock, respectively were excluded in the computation of diluted net loss per share applicable to Common Shareholders because exercise or conversion would have an antidilutive effect on the net loss per share.

## Note 5. Accounts Receivable

Accounts receivable are included on the accompanying consolidated balance sheets net of an allowance for doubtful accounts. The total allowance for doubtful accounts at June 30, 2011 and December 31, 2010 was \$24,686 and \$133,080, respectively.

## Note 6. Inventories

Inventories are stated at the lower of cost, determined using the first-in, first-out basis, or market value and are all categorized as finished goods. The costs of inventory include the purchase price, inbound freight and duties, conversion costs and certain allocated production overhead costs.

Inventory valuation 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 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:

|                   | June 30,<br>2011 | December 31,<br>2010 |
|-------------------|------------------|----------------------|
| Finished goods    | \$1,718,958      | \$2,156,026          |
| Less reserves     | (703,096)        | (884,035)            |
| Total inventories | \$1,015,862      | \$1,271,991          |



TALON INTERNATIONAL, INC.

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Note 7. 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 8) 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. This amendment redefined the financial covenants and cancelled 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 term loans under Loan Agreement. In connection with this amendment 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. 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 Loan Agreement, as amended, the Company is 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 financial covenants, as amended, 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 financial covenants for two quarters ended March 31, 2009, and in connection with such failures, further amended the Loan Agreement that, among other things, required 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. The Company did not have sufficient resources to pay this obligation on the maturity date, and entered into the Recapitalization Agreement in settlement of this debt.

TALON INTERNATIONAL, INC.

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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. Upon execution of the amendment, CVC waived all prior events of default under the Loan Agreement.

At June 30, 2011 and December 31, 2010, the Company had no borrowings under the revolving credit facility, and was in compliance with all loan covenants. Borrowings under the Loan Agreement are secured by all of the Company's assets.

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 three and six months ended June 30, 2011 was \$7,500 and \$15,000, respectively. For the three and six months ended June 30, 2010 total interest expense was \$891,210 and \$1,597,082, respectively. Total interest expense in the periods was comprised as follows:

- Interest on debt related to the Loan Agreement for the three months ended June 30, 2011 and 2010 was \$0 and \$454,595, respectively. For the six months ended June 30, 2011 and 2010 interest on debt related to Loan Agreement was \$0 and \$747,986, respectively.
- Amortization of the debt discount related to the Loan Agreement for the three months ended June 30, 2011 and 2010 was \$0 and \$374,557, respectively. For the six months ended June 30, 2011 and 2010 amortization of the debt discount related to the Loan Agreement was \$0 and \$725,982, respectively.
- Amortization of deferred financing costs related to the Loan Agreement for the three months ended June 30, 2011 and 2010 was \$7,500 and \$62,058, respectively. For the six months ended June 30, 2011 and 2010 amortization of deferred financing costs related to the Loan Agreement was \$15,000 and \$123,114, respectively

Note 8. Series B Convertible Preferred Stock and Stockholders' Equity (Deficit)

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 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:



TALON INTERNATIONAL, INC.

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- 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.
- 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, or other deemed liquidation, 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.

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- 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.

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”. Per FASB ASC No. 470-50 a loss on extinguishment of debt of \$570,915 was recorded on July 30, 2010 and was 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 an 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:



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

- 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 accumulated deficit 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 annual dividend (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.

Series B Preferred Stock activity during the six months ended June 30, 2011 is as follows:

|                                                          |               |
|----------------------------------------------------------|---------------|
| Series B Preferred Stock as of December 31, 2010         | \$ 17,820,464 |
| Series B Preferred Stock Liquidation Preference Increase | 668,267       |
| Series B Preferred Stock as of March 31, 2011            | 18,488,731    |
| Series B Preferred Stock Liquidation Preference Increase | 668,268       |
| Series B Preferred Stock as of June 30, 2011             | \$ 19,156,999 |

## 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:

- Messrs. Schnell and Dyne agreed with CVC to vote their shares of Company 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 the Company is a constituent party, or any sale of all or substantially all of the Company’s assets (a “Triggering Transaction”), in each case to the extent such transaction is first approved by CVC. Messrs. Schnell and Dyne also provided CVC with an irrevocable proxy to vote their shares of Company voting stock in favor of any such transaction.

TALON INTERNATIONAL, INC.

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- CVC agreed with the Company 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 with the Company 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. CVC also provided the Company's chief executive officer with an irrevocable proxy to vote its shares of the Company voting stock in favor of such nominees.
- 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.
- CVC agreed with the Company 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).



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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 shares contain restrictions related to the transfer of the shares and registration rights. 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. The Company is currently in litigation with this licensor (See Note 11).

Note 9. Stock-Based Compensation

The Company accounts for stock-based awards to employees and directors in accordance with FASB ASC 718, "Compensation - Stock Compensation", which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. Options issued to consultants are accounted for in accordance with the provisions of FASB ASC 505-50, "Equity-Based Payments to Non-Employees".

Stock Options

The Company's 2008 and 2007 Stock Incentive Plans, as amended, authorize up to 4,810,000 and 2,600,000 shares of common stock, respectively, for issuance pursuant to awards granted to individuals under the plans. The Company's 1997 Stock Incentive Plan authorized the issuance of up to 6,000,000 shares of common stock pursuant to stock-based incentive awards granted to individuals.

Option awards are granted with an exercise price equal to the average market price of the Company's stock for the five trading days following the date of the grant. Those option awards generally vest over periods determined by the Board from immediate to four years of continuous service and have ten year contractual terms. (See Note 8).

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 and their option grants. On July 30, 2010 the Company entered into new executive employment agreements with Messrs. Schnell and Dyne and Messrs. Schnell and Dyne agreed to cancel all option grants previously awarded to them on or before December 31, 2007. Accordingly, option grants constituting a total of 1,005,500 shares of common stock were cancelled effective July 30, 2010 (See Note 8).

Options to purchase 1,355,000 shares of common stock were granted under the 2008 Stock Incentive Plan during six months ended June 30, 2011. No options were granted for the three and six months ended June 30, 2010.

During three months ended June 30, 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 total intrinsic value of the options exercised was \$4,375 (or \$0.04 per share). No options were exercised for the three and six months ended June 30, 2010.

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(Unaudited)

As of June 30, 2011, the Company had \$172,064 of unamortized stock-based compensation expense related to options issued to employees and directors, which will be recognized over the weighted average period of 2.7 years. As of June 30, 2010, unamortized stock-based compensation expense related to options issued to employees and directors was \$98,342, which is being recognized over the weighted average period of approximately 1.5 years.

The following table summarizes the activity in the Company's share based plans during the six months ended June 30, 2011.

|                                       | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price |
|---------------------------------------|---------------------|------------------------------------------|
| Employees and Directors               |                     |                                          |
| Options outstanding - January 1, 2011 | 5,147,100           | \$0.35                                   |
| Granted                               | 1,355,000           | \$0.10                                   |
| Exercised                             | -                   | \$-                                      |
| Cancelled                             | (135,417 )          | \$0.11                                   |
| Options outstanding - March 31, 2011  | 6,366,683           | \$0.30                                   |
| Granted                               | -                   | \$-                                      |
| Exercised                             | (109,375 )          | \$0.11                                   |
| Cancelled                             | (130,208 )          | \$3.83                                   |
| Options outstanding - June 30, 2011   | 6,127,100           | \$0.23                                   |

## Restricted Stock Units (RSU's)

On July 30, 2010, the Company granted 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 will vest 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 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). As of June 30, 2011, the Company had \$1,306,307 of unamortized stock-based compensation expense related to RSU's. The remaining expense will be recognized over the remaining weighted average period of 1.4 years.

## Note 10. Income taxes

The Company accrues interest and penalties related to unrecognized tax benefits in interest expense. For each of the three months ended June 30, 2011 and 2010, the Company accrued interest and penalties for unrecognized tax benefits of \$3,975. At June 30, 2011 and December 31, 2010, the Company had \$101,475 and \$93,525, respectively, of accrued interest and penalties associated with the unrecognized tax liabilities.



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Net deferred tax assets of \$0 and \$111,454 as of June 30, 2011 and December 31, 2010, respectively, and were related to the Company's foreign operations and are included in other assets. Due to prior operating losses incurred, no benefit for domestic income taxes and no benefit for a portion of the foreign income taxes have been recorded because there is not sufficient evidence to determine that the Company will be able to utilize its net operating loss carryforwards to offset future taxable income.

Other tax liabilities were \$61,159 and \$3,215 as of June 30, 2011 and December 31, 2010, respectively, and were included in other accrued expenses. Current receivable for income taxes totaled \$47,935 and \$87,638, respectively, as of June 30, 2011 and December 31, 2010.

Long term deferred income tax liabilities totaled \$710,445 and \$608,554 as of June 30, 2011 and December 31, 2010, respectively. The deferred income tax liability includes 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 and tax basis difference related to the Company's foreign operations (\$29,259 and \$0 as of June 30, 2011 and December 31, 2010, respectively).

Note 11. Commitments and Contingencies

On April 16, 2004, the Company 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 the Company's exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. It is the Company's position that the agreement with Pro-Fit gives the Company exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. The Company also filed a second civil action against Pro-Fit and related companies in the California Superior Court which was removed to the United States District Court, Central District of California. In the second quarter of 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. As a consequence of the Chapter 15 filings, all litigation by the Company against Pro-Fit has been stayed. The Company has incurred significant legal fees in this litigation, and unless the case is settled or resolved, may continue to incur additional legal fees in order to assert its rights and claims against Pro-Fit and any successor to those assets of Pro-Fit that are subject to its exclusive license and intellectual property agreement with Pro-Fit and to defend against any counterclaims.

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.

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:



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

- 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 12. 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:

|                        | Three Months Ended<br>June 30, 2011 |             |         |              |
|------------------------|-------------------------------------|-------------|---------|--------------|
|                        | Talon                               | Trim        | Tekfit  | Consolidated |
| Net sales              | \$7,299,479                         | \$5,450,562 | \$2,240 | \$12,752,281 |
| Cost of goods sold     | 5,348,390                           | 3,340,015   | 538     | 8,688,943    |
| Gross profit           | \$1,951,089                         | \$2,110,547 | \$1,702 | 4,063,338    |
| Operating expenses     |                                     |             |         | 3,062,200    |
| Income from operations |                                     |             |         | \$1,001,138  |

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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|                        | Three Months Ended<br>June 30, 2010 |             |            |              |
|------------------------|-------------------------------------|-------------|------------|--------------|
|                        | Talon                               | Trim        | Tekfit     | Consolidated |
| Net sales              | \$9,752,437                         | \$5,220,635 | \$-        | \$14,973,072 |
| Cost of goods sold     | 7,316,812                           | 3,274,272   | 42,751     | 10,633,835   |
| Gross profit           | \$2,435,625                         | \$1,946,363 | \$(42,751) | 4,339,237    |
| Operating expenses     |                                     |             |            | 2,641,468    |
| Income from operations |                                     |             |            | \$1,697,769  |

|                        | Six Months Ended<br>June 30, 2011 |             |         |              |
|------------------------|-----------------------------------|-------------|---------|--------------|
|                        | Talon                             | Trim        | Tekfit  | Consolidated |
| Net sales              | \$12,781,001                      | \$9,197,233 | \$2,240 | \$21,980,474 |
| Cost of goods sold     | 9,272,461                         | 5,753,510   | 612     | 15,026,583   |
| Gross profit           | \$3,508,540                       | \$3,443,723 | \$1,628 | 6,953,891    |
| Operating expenses     |                                   |             |         | 6,243,258    |
| Income from operations |                                   |             |         | \$710,633    |

|                        | Six Months Ended<br>June 30, 2010 |             |            |              |
|------------------------|-----------------------------------|-------------|------------|--------------|
|                        | Talon                             | Trim        | Tekfit     | Consolidated |
| Net sales              | \$14,686,739                      | \$8,521,593 | \$-        | \$23,208,332 |
| Cost of goods sold     | 10,938,684                        | 5,428,467   | 65,251     | 16,432,402   |
| Gross profit (loss)    | \$3,748,055                       | \$3,093,126 | \$(65,251) | 6,775,930    |
| Operating expenses     |                                   |             |            | 5,253,863    |
| Income from operations |                                   |             |            | \$1,522,067  |

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company distributes its products internationally and has reporting requirements based on geographic regions. Revenues are attributed to countries based upon customer delivery locations and the net book value of long-lived assets (consisting of property and equipment and intangible) is attributed to countries based on the location of the assets, as follows:

| Sales:<br>Country / Region | Three Months Ended<br>June 30, |              | Six Months Ended<br>June 30 |              |
|----------------------------|--------------------------------|--------------|-----------------------------|--------------|
|                            | 2011                           | 2010         | 2011                        | 2010         |
| United States              | \$914,864                      | \$1,201,996  | \$1,796,911                 | \$2,007,615  |
| Hong Kong                  | 4,273,926                      | 4,752,797    | 7,496,328                   | 7,974,739    |
| China                      | 3,539,886                      | 4,556,589    | 5,147,472                   | 6,091,380    |
| Korea                      | 713,343                        | 300,504      | 1,120,558                   | 507,352      |
| Bangladesh                 | 374,558                        | 706,696      | 1,367,182                   | 1,387,299    |
| Other                      | 2,935,704                      | 3,454,490    | 5,052,023                   | 5,239,947    |
| Total                      | \$12,752,281                   | \$14,973,072 | \$21,980,474                | \$23,208,332 |

| Long-lived Assets: | June 30,<br>2011 | December 31,<br>2010 |
|--------------------|------------------|----------------------|
|                    |                  |                      |
| United States      | \$4,515,466      | \$4,623,448          |
| Hong Kong          | 752,392          | 884,344              |
| China              | 156,646          | 182,980              |
| Other              | 1,341            | 2,306                |
| Total              | \$5,425,845      | \$5,693,078          |

## Note 13. Related Party Notes and Transactions

On July 30, 2010, the Company entered into a Recapitalization Agreement with CVC (See Note 7 and Note 8). As a result of this transaction CVC (currently the sole holder of the Series B Preferred Stock) has become the majority stockholder in the Company. Commencing August 1, 2010, a \$5,000 monthly debt monitoring fee has been paid to CVC. A \$60,000 fee was paid to CVC in consideration of CVC entering into an amendment to the Loan Agreement during the quarter ended September 30, 2010.

Colin Dyne, brother of both Mark Dyne, the Chairman of the Board of Directors of the Company and Larry Dyne, the President of the Company, is also a director, officer and significant stockholder of People's Liberation, Inc., the parent company of William Rast Sourcing. During the three and six months ended June 30, 2011, the Company had sales of \$81,824 and \$139,003, respectively, to William Rast Sourcing. During the three and six months ended June 30, 2010 the Company had sales of \$150,166 and \$230,247, respectively, to William Rast Sourcing. Accounts receivable of \$2,404 and \$26,711 were outstanding from William Rast Sourcing at June 30, 2011 and December 31, 2010, respectively.



TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 2% of the 7% earned applied to a note receivable balance. For the three months ended June 30, 2011 and 2010 commissions of \$14,172 and \$34,155 were paid, respectively. For the six months ended June 30, 2011 and 2010 commissions of \$14,172 and \$55,540 were paid, respectively. A 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. For the three and six months ended June 30, 2010 \$17,679 and \$27,057, respectively in commissions were applied to the note receivable balance. 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.

Notes payable to related parties includes demand notes and advances to parties related to or affiliated with Mark Dyne, the Chairman of the Board of Directors of the Company and a significant stockholder. The balance of demand notes payable and interest expense due to Mark Dyne and affiliated parties at June 30, 2011 and December 31, 2010 was \$239,993 and \$236,448, respectively.

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 \$95,548 and \$164,761, as of June 30, 2011 and December 31, 2010, respectively, in consideration of the final payments under the agreement. Interest related to the amount owed amounted to \$2,527 and \$5,787 for the three and six months ended June 30, 2011, respectively. Related interest amounted to \$5,367 and \$54,536 for the three and six months ended June 30, 2010, respectively.

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, issued on August 6, 2009 in partial satisfaction of 2008 annual incentive payments to which Mr. Schnell was entitled, bears 6% interest annually and the maturity date is the earlier of December 31, 2011 or ten days following Mr. Schnell's employment termination date. The balance of the note payable and accrued interest expense due to Mr. Schnell at June 30, 2011 and December 31, 2010 was \$39,946 and \$38,768, respectively.

Note 14. Subsequent Events

The Company evaluated subsequent events after the balance sheet date of June 30, 2011 through the date these unaudited financial statements were issued.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Forward Looking Statements

This report and other documents we file with the 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 unaudited consolidated financial statements. This management's discussion and analysis is provided as a supplement to, and should be read in conjunction with, our unaudited consolidated financial statements and accompanying notes.

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, distribution and manufacturing locations, strategic manufacturing relationships and joint ventures. The manufacturing joint ventures, 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 business focuses on serving as an outsourced zipper and trim supplier, product 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 supplying 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 promote this product to customers have been limited by a licensing dispute. As described more fully in this report under Item 1. "Legal Proceedings", we are in litigation with Pro-Fit Holdings Limited related to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured under Pro-Fit's patented technology. For the three and six months ended June 30, 2011 we had \$2,240 revenue from the sale of products incorporating the stretch waistband technology. We derived no revenue from the sale of products incorporating the stretch waistband technology for the three and six months ended June 30, 2010.



## Seasonality

We typically experience seasonal fluctuations in sales volume consistent with the purchase demands of the apparel industry. 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.

## Results of Operations

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

|                                     | Three Months Ended<br>June 30,<br>2011 |   | 2010  |   | Six Months Ended<br>June 30,<br>2011 |   | 2010  |    |
|-------------------------------------|----------------------------------------|---|-------|---|--------------------------------------|---|-------|----|
|                                     |                                        | % |       |   |                                      | % |       | %  |
| Net sales                           | 100.0                                  | % | 100.0 | % | 100.0                                | % | 100.0 | %  |
| Cost of goods sold                  | 68.1                                   |   | 71.0  |   | 68.4                                 |   | 70.8  |    |
| Gross profit                        | 31.9                                   |   | 29.0  |   | 31.6                                 |   | 29.2  |    |
| Sales and marketing expenses        | 8.4                                    |   | 5.3   |   | 8.9                                  |   | 6.2   |    |
| General and administrative expenses | 15.7                                   |   | 12.4  |   | 19.5                                 |   | 16.4  |    |
| Interest expense, net               | 0.2                                    |   | 5.9   |   | 0.2                                  |   | 6.9   |    |
| Income taxes                        | 2.5                                    |   | 1.1   |   | 1.8                                  |   | 0.6   |    |
| Net income (loss)                   | 5.1                                    | % | 4.3   | % | 1.2                                  | % | (0.9) | )% |

## Sales

For the three and six months ended June 30, 2011 and 2010, sales by geographic region based on the location of the customer as a percentage of sales were as follows:

| Region        | Three Months Ended<br>June 30,<br>2011 |   | 2010  |   | Six Months Ended<br>June 30,<br>2011 |   | 2010  |   |
|---------------|----------------------------------------|---|-------|---|--------------------------------------|---|-------|---|
|               |                                        | % |       |   |                                      | % |       | % |
| United States | 7.2                                    | % | 8.0   | % | 9.6                                  | % | 8.7   | % |
| Hong Kong     | 33.5                                   |   | 31.7  |   | 34.9                                 |   | 34.4  |   |
| China         | 27.8                                   |   | 30.4  |   | 17.4                                 |   | 26.2  |   |
| Korea         | 5.6                                    |   | 2.0   |   | 4.4                                  |   | 2.2   |   |
| Bangladesh    | 2.9                                    |   | 4.7   |   | 10.8                                 |   | 6.0   |   |
| Other         | 23.0                                   |   | 23.2  |   | 22.9                                 |   | 22.5  |   |
|               | 100.0                                  | % | 100.0 | % | 100.0                                | % | 100.0 | % |

Sales for the three months ended June 30, 2011 were \$12.8 million, a decline of \$2.2 million or 14.8% from the same period in 2010. Sales for the six months ended June 30, 2011 were \$22.0 million, a decline of \$1.2 million or 5.3% from the same period in 2010. The net decline reflected continued economic weakness in the U.S. apparel market resulting in lower demand for our products, and a sharp decline in the demand from price sensitive mass retailer accounts who shifted their purchases to buy directly from factories in Asia, partially offset by additional new

programs and new customers.

## Gross Profit

Gross profit for the three months ended June 30, 2011 was \$4.1 million as compared to \$4.3 million for the same period in 2010. The reduction in gross profit for the three months ended June 30, 2011 as compared to the same period in 2010 was principally attributable to lower overall sales volumes offset by improved product mix, lower freight and duty costs and lower manufacturing support and inventory obsolescence costs.

Gross profit for the six months ended June 30, 2011 was \$7.0 million as compared to \$6.8 million for the same period in 2010. The improvement in gross profit for the six months ended June 30, 2011 as compared to the same period in 2010 was principally attributable to improved product mix, and lower freight and duties costs, manufacturing support and inventory obsolescence costs offset by lower overall sales volumes.

A recap of the change in gross margin for the three and six months ended June 30, 2011 as compared with the same period in 2010 is as follows:

|                                                                | Three Months Ended<br>June 30, 2011<br>compared to same<br>period in 2010<br>\$ in 000's(1) |                  | Six Months Ended<br>June 30, 2011<br>compared to same<br>period in 2010<br>\$ in 000's(1) |                  |
|----------------------------------------------------------------|---------------------------------------------------------------------------------------------|------------------|-------------------------------------------------------------------------------------------|------------------|
|                                                                |                                                                                             | % <sup>(1)</sup> |                                                                                           | % <sup>(1)</sup> |
| Gross profit increased (reduced) as a result of:               |                                                                                             |                  |                                                                                           |                  |
| Lower volumes                                                  | (820 )                                                                                      | (18.9 )          | (463 )                                                                                    | (6.9 )           |
| Mix of products                                                | 384                                                                                         | 8.9              | 457                                                                                       | 6.7              |
| Reduced freight and duty costs                                 | 80                                                                                          | 1.8              | 68                                                                                        | 1.0              |
| Reduced manufacturing support and inventory obsolescence costs | 80                                                                                          | 1.8              | 116                                                                                       | 1.7              |
| Gross profit increase (decrease)                               | (276 )                                                                                      | (6.4 )           | 178                                                                                       | 2.5              |

(1) Represents the amount or percentage, as applicable, change in each item in the three and six months ended June 30, 2011 period, as compared to the same period in 2010.

## Sales and marketing expenses

Sales and marketing expenses for the three months ended June 30, 2011 were \$1.1 million, or 8.4% of sales, as compared to \$0.8 million, or 5.3% of sales, for the same period in 2010. Sales and marketing expenses for the six months ended June 30, 2011 were \$2.0 million, or 8.9% of sales, as compared to \$1.4 million, or 6.2% of sales, for the same period in 2010. Sales expenses increased due to the expansion of our sales force in the US during the third quarter of 2010 and second quarter of 2011 and in Asia during first quarter of 2011.

## General and administrative expenses

General and administrative expenses for the three months ended June 30, 2011 were \$2.0 million, or 15.7% of sales, as compared with \$1.9 million, or 12.4% of sales, for the same period in 2010. The general and administrative expenses in 2010 benefited from the sale of the Note Receivable from Related party with a recovery of bad debts of \$0.3 million. Increased charges for non-cash compensation expenses of \$0.2 million in 2011 offset by lower professional fees and lower facilities expenses of \$0.4 million, and the bad debt recovery in 2010 generally attributed to the change from prior year. General and administrative expenses for the six months ended June 30, 2011 were \$4.3 million, or 19.5% of sales, as compared with \$3.8 million, or 16.4% of sales, for the same period in 2010. The increase of \$0.5 million mainly reflected increased charges for non-cash compensation expenses of \$0.4 million, the beneficial effect of the sale of the Note Receivable from Related party of \$0.3 million in 2010, and increased compensation of \$0.1 million offset by lower professional fees and lower facilities expenses of \$0.2 million and lower depreciation expenses of \$0.1 million.

## Interest expense and interest income

Interest expense for the three months ended June 30, 2011 decreased by approximately \$879,000, as compared to the same period in 2010, to \$25,000. Interest expense for the six months ended June 30, 2011 decreased by approximately \$1,576,000, as compared to the same period in 2010, to \$44,000. The decrease resulted from the elimination of amounts owed under our former revolver and term notes with CVC that were converted into preferred stock as of July 30, 2010. (See Note 7 and note 8 in the accompanying Notes to Consolidated Financial Statements).

Interest income for the three and six months ended June 30, 2011 decreased by approximately \$17,000 and \$26,000, respectively, as compared to the same periods in 2010. The decreases were due primarily to the recognition of and collection of interest income on the Related Party note receivable in 2010 which we sold to a third party on June 29, 2010.

A brief summary of interest expense and interest income is presented below:

|                                                             | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |             |
|-------------------------------------------------------------|--------------------------------|-----------|------------------------------|-------------|
|                                                             | 2011                           | 2010      | 2011                         | 2010        |
| Amortization of deferred financing costs and debt discounts | \$7,500                        | \$436,615 | \$15,000                     | \$849,096   |
| Other interest expense                                      | 17,187                         | 466,705   | 28,701                       | 770,805     |
| Interest expense                                            | 24,687                         | 903,320   | 43,701                       | 1,619,901   |
| Interest income                                             | (1,494)                        | (18,499)  | (2,068)                      | (27,883)    |
| Interest expense, net                                       | \$23,193                       | \$884,821 | \$41,633                     | \$1,592,018 |

## Income taxes

Provision for (recovery from) income taxes for the three and six months ended June 30, 2011 was approximately \$322,000 and \$414,000, respectively. Provision for income taxes for the three and six months ended June 30, 2010 was approximately \$166,000 and \$131,000, respectively. During the three and six months ended June 30, 2011 we recorded a deferred income tax liability in amount of approximately \$36,000 and \$73,000, respectively, 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 10 in the accompanying Notes to Consolidated Financial Statements). The provision for 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 is offset by a full valuation reserve.

## Liquidity and Capital Resources

The following table summarizes selected financial data at:

|                                  | (\$ in thousands) |                      |
|----------------------------------|-------------------|----------------------|
|                                  | June 30,<br>2011  | December 31,<br>2010 |
| Cash and cash equivalents        | \$6,128           | \$2,795              |
| Total assets                     | \$17,012          | \$13,828             |
| Current liabilities              | \$9,687           | \$7,442              |
| Long term liabilities            | \$1,499           | \$1,367              |
| Preferred stock                  | \$19,157          | \$17,820             |
| Stockholders' equity (deficit)   | \$(13,331)        | \$(12,801)           |
| Total equity and preferred stock | \$5,826           | \$5,019              |

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

Cash and cash equivalents increased by approximately \$3,332,000 at June 30, 2011 as compared to December 31, 2010, principally due to cash provided by operating activities of approximately \$3,374,000, proceeds from the sale of equipment of \$55,000, and proceeds from the exercise of stock options of approximately \$12,000, partially offset by the acquisition of property and equipment of \$103,000.

Cash provided by operating activities is our primary recurring source of funds, and reflects the net loss from operations excluding non-cash charges, and changes in operating capital. The six months ended June 30, 2011 and 2010 reflected net cash provided by operating activities of approximately \$3,374,000 and \$1,826,000, respectively.

The net cash provided by operating activities during the six months ended June 30, 2011 and 2010 resulted principally from:

|                                                 | (\$ in thousands) |          |
|-------------------------------------------------|-------------------|----------|
|                                                 | Six Months Ended  |          |
|                                                 | June 30,          |          |
|                                                 | 2011              | 2010     |
| Net income before non-cash expenses             | \$1,322           | \$1,089  |
| Reduced (increased) inventory                   | 298               | (38 )    |
| Reduced (increased) accounts receivable         | (452 )            | (1,182 ) |
| Increased accounts payable and accrued expenses | 2,208             | 2,063    |
| Other reductions in operating capital           | (2 )              | (106 )   |
| Cash provided by operating activities           | \$3,374           | \$1,826  |

Net cash (used in) investing activities for the six months ended June 30, 2011 and 2010 was approximately \$(48,000) and \$(21,000), respectively, due to acquisition of property and equipment in the six months ended June 30, 2011 and 2010 of approximately \$103,000 and \$21,000, respectively, offset by proceeds from sale of equipment in amount of \$55,000 during first six month ended June 30, 2011.

Net cash used in financing activities for the six months ended June 30, 2011 and 2010 was approximately \$9,000 and \$52,000, respectively, reflecting proceeds from exercise of stock options in amount of approximately \$12,000 in 2011 offset by repayment of borrowings under capital leases in the six months ended June 30, 2011 and 2010 of approximately \$3,000 and \$52,000, respectively.

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.

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. 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 \$11,548,098 under the term notes, and \$5,158,587 under the revolving credit note, all of which was exchanged for the Series B Preferred Stock. See Note 8 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. 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 our assets. At June 30, 2011 and December 31, 2010, we had no borrowings under the revolving credit facility portion of the Loan Agreement and 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 June 30, 2011 are approximately \$21,000 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 June 30, 2011 and December 31, 2010 was approximately \$280,000 and \$275,000, respectively. Included in this balance are demand notes which bear interest at 10% (balance as of June 30, 2011 and December 31, 2010 of approximately \$240,000 and \$236,000, respectively), have no scheduled monthly payments and are due within fifteen days following demand. The remainder of the notes payable to related parties includes our note payable to an officer for approximately \$40,000 and \$39,000 at June 30, 2011 and December 31, 2010, respectively. The note bears 6% interest annually and the maturity date is the earlier of December 31, 2011 or ten days following employment termination date.

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 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 and Off-Balance Sheet Arrangements

The following summarizes our contractual obligations at June 30, 2011:

| Contractual Obligations             | Payments Due by Period (\$ in thousands) |                     |              |              |                  |
|-------------------------------------|------------------------------------------|---------------------|--------------|--------------|------------------|
|                                     | Total                                    | Less than<br>1 Year | 1-3<br>Years | 4-5<br>Years | After<br>5 Years |
| Notes payable to related parties(1) | \$280                                    | \$280               | \$-          | \$-          | \$-              |
| Capital lease obligations           | 25                                       | 9                   | 16           | -            | -                |
| Operating leases                    | 1,115                                    | 531                 | 584          | -            | -                |
| Other notes payable                 | 65                                       | 65                  | -            | -            | -                |
| Total Obligations                   | \$1,485                                  | \$885               | \$600        | \$-          | \$-              |

(1) The majority of notes payable to related parties is due upon or near demand for payment and includes accrued interest payable through June 30, 2011.

At June 30, 2011 and December 31, 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 do not have any of the risks associated with financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

## Related Party Transactions

See Note 13 in the accompanying Notes to Consolidated Financial Statements for a discussion of related party transactions.

## 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, 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 net bad debt expenses, recoveries and allowances for the three and six months ended June 30, 2011 and 2010 are as follows:

|                                                  | Three Months Ended<br>June 30, |               | Six Months Ended<br>June 30, |               |
|--------------------------------------------------|--------------------------------|---------------|------------------------------|---------------|
|                                                  | 2011                           | 2010          | 2011                         | 2010          |
| Bad debt expenses for accounts receivable        | \$ (11,107 )                   | \$ (56,240 )  | \$ (720 )                    | \$ (62,351 )  |
| Bad debt recovery, related party note receivable | \$ -                           | \$ (275,000 ) | \$ -                         | \$ (275,000 ) |
| Bad debt recovery, other accounts receivable     | \$ -                           | \$ -          | \$ -                         | \$ (11,332 )  |
| Allowance for doubtful accounts,                 |                                |               |                              |               |
| Accounts receivable                              | \$ 24,686                      | \$ 160,001    | \$ 24,686                    | \$ 160,001    |

- Inventories are stated at the lower of cost, determined using the first-in, first-out (“FIFO”) 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. Inventory reserve is reduced following legacy inventory sale and write-off of reserved inventory and increased by additions to reserve for slow moving inventory.
- 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 10 in the accompanying Notes to Consolidated Financial Statements.

- 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 FASB ASC 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. 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 position or results of operations if adversely determined against us.

#### 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Not Applicable

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

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

As of the end of the period covered by this report, management, with the participation of Lonnie D. Schnell, our principal executive officer and principal financial officer, and James E. Reeder, our principal accounting 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 and Mr. Reeder concluded that these disclosure controls and procedures were effective as of the end of the period covered in this Quarterly Report on Form 10-Q.

Changes in Internal Control over Financial Reporting

During the quarter ended June 30, 2011, there were no changes in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II  
OTHER INFORMATION

Item 1. Legal Proceedings

On April 16, 2004, we 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. It is our position that the agreement with Pro-Fit gives us exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. We also filed a second civil action against Pro-Fit and related companies in the California Superior Court which was removed to the United States District Court, Central District of California. In the second quarter of 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. As a consequence of the Chapter 15 filings, all litigation by us against Pro-Fit has been stayed. We have incurred significant legal fees in this litigation, and unless the case is settled or resolved, may continue to incur additional legal fees in order to assert its rights and claims against Pro-Fit and any successor to those assets of Pro-Fit that are subject to our exclusive license and intellectual property agreement with Pro-Fit and to defend against any counterclaims.

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 1A. Risk Factors

Risk factors are contained in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010. No material change to such risk factors has occurred during the three months ended June 30, 2011.

Item 6. Exhibits

Exhibit No. Description

- 3.1 Bylaws of Talon International, Inc. Incorporated by reference to Exhibit 3.2 to Form SB-2 filed on October 21, 1997.
- 3.2 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.
- 10.25 + Employment Agreement, dated July 30, 2010, between Talon International, Inc. and Lonnie D. Schnell.
- 10.26 + Employment Agreement, dated July 30, 2010, between Talon International, Inc. and Larry Dyne.
- 31.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS\*\* XBRL Instance
- 101.SCH\*\* XBRL Taxonomy Extension Schema
- 101.CAL\*\* XBRL Taxonomy Extension Calculation
- 101.DEF\*\* XBRL Taxonomy Extension Definition
- 101.LAB\*\* XBRL Taxonomy Extension Labels
- 101.PRE\*\* XBRL Taxonomy Extension Presentation

+ Indicates a management contract or compensatory plan or arrangement.

\*\* XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes 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.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

August 11, 2011

/s/ Lonnie D. Schnell  
Lonnie D. Schnell  
Chief Executive Officer and Chief  
Financial Officer  
(Principal Executive Officer and  
Principal Financial Officer)

/s/ James E. Reeder  
James E. Reeder  
Vice President, Corporate Controller  
(Principal Accounting Officer)