

TALON INTERNATIONAL, INC.
Form 10-Q
August 12, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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, 2010.

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

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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):

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

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

At August 11, 2010 the issuer had 20,291,433 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, 2010 (Unaudited) | December 31, 2009 |
|---|---------------------------------|----------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 4,016,772 | \$ 2,264,606 |
| Accounts receivable, net | 4,555,367 | 3,021,642 |
| Inventories, net | 1,534,351 | 1,679,302 |
| Prepaid expenses and other current assets | 256,386 | 240,554 |
| Total current assets | 10,362,876 | 7,206,104 |
| Property and equipment, net | 1,898,386 | 2,280,586 |
| Intangible assets, net | 4,110,751 | 4,110,751 |
| Other assets | 203,538 | 236,386 |
| Total assets | \$ 16,575,551 | \$ 13,833,827 |
| Liabilities and Stockholders' Deficit | | |
| Current liabilities: | | |
| Accounts payable | \$ 8,070,251 | \$ 6,337,368 |
| Accrued expenses | 2,184,978 | 2,678,659 |
| Revolver note payable | - | 4,988,988 |
| Term notes payable, net of discounts | - | 9,876,114 |
| Notes payable to related parties | 270,527 | 265,871 |
| Other notes and current portion of capital lease obligations | 67,895 | 115,336 |
| Total current liabilities | 10,593,651 | 24,262,336 |
| Revolver note payable and related interest (Note 7) | 5,096,424 | - |
| Term notes payable and related interest (Note 7) | 11,444,421 | - |
| Capital lease obligations, net of current portion | 20,543 | 23,477 |
| Other liabilities | 693,540 | 726,875 |
| Total liabilities | 27,848,579 | 25,012,688 |
| Commitments and contingencies (Note 10) | | |
| Stockholders' Deficit: | | |
| Preferred stock Series A, \$0.001 par value; 250,000 shares authorized; | | |
| n shares issued or outstanding | - | - |
| Common stock, \$0.001 par value, 100,000,000 shares authorized; 20,291,433 shares issued and outstanding at June 30, 2010 and December 31, 2009 | 20,291 | 20,291 |
| Additional paid-in capital | 55,183,716 | 55,070,568 |
| Accumulated deficit | (66,544,976) | (66,344,009) |
| Accumulated other comprehensive income | 67,941 | 74,289 |

| | | |
|---|---------------|---------------|
| Total stockholders' deficit | (11,273,028) | (11,178,861) |
| Total liabilities and stockholders' deficit | \$ 16,575,551 | \$ 13,833,827 |

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, | |
|--|--------------------------------|---------------|------------------------------|-----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net sales | \$ 14,973,072 | \$ 12,583,765 | \$ 23,208,332 | \$ 19,099,519 |
| Cost of goods sold | 10,633,835 | 9,022,318 | 16,432,402 | 13,553,905 |
| Gross profit | 4,339,237 | 3,561,447 | 6,775,930 | 5,545,614 |
| Sales and marketing expenses | 787,531 | 717,000 | 1,444,353 | 1,418,814 |
| General and administrative expenses | 1,853,937 | 2,012,402 | 3,809,510 | 3,829,925 |
| Total operating expenses | 2,641,468 | 2,729,402 | 5,253,863 | 5,248,739 |
| Income from operations | 1,697,769 | 832,045 | 1,522,067 | 296,875 |
| Interest expense, net | 884,821 | 661,087 | 1,592,018 | 1,298,038 |
| Net income (loss) before provision for income taxes | 812,948 | 170,958 | (69,951) | (1,001,163) |
| Provision for income taxes | 166,272 | 96,103 | 131,016 | 102,510 |
| Net income (loss) | \$ 646,676 | \$ 74,855 | \$ (200,967) | \$ (1,103,673) |
| Basic and diluted net income (loss) per share | \$ 0.03 | \$ 0.01 | \$ (0.01 | \$ (0.05) |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 20,291,433 | 20,291,433 | 20,291,433 | 20,291,433 |
| Diluted | 20,966,187 | 20,291,433 | 20,291,433 | 20,291,433 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, | |
|---|---------------------------|----------------|
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net loss | \$ (200,967) | \$ (1,103,673) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation, amortization, and loss from disposal of equipment | 404,101 | 369,343 |
| Amortization of deferred financing cost and debt discounts | 849,096 | 699,340 |
| Stock based compensation | 113,148 | 90,233 |
| Bad debt (recoveries) expense | (73,683) | 77,373 |
| Related party note recovery | (275,000) | - |
| Inventory valuation provisions | 182,936 | - |
| Changes in operating assets and liabilities: | | |
| Accounts and notes receivable, including related parties | (1,182,388) | (1,632,941) |
| Inventories | (37,985) | (266,046) |
| Prepaid expenses and other current assets | (15,717) | (178,697) |
| Other assets | 33,048 | 110,473 |
| Accounts payable and accrued expenses | 2,062,995 | 1,819,604 |
| Other liabilities | (33,335) | (42,050) |
| Net cash provided by (used in) operating activities | 1,826,249 | (57,041) |
| Cash flows from investing activities: | | |
| Proceeds from sale of equipment | - | 1,822 |
| Acquisitions of property and equipment | (21,014) | (419,082) |
| Net cash used in investing activities | (21,014) | (417,260) |
| Cash flows from financing activities: | | |
| Revolver note borrowings | - | 351,495 |
| Term note borrowings | - | 125,000 |
| Payment of notes payable | - | (97,637) |
| Payment of capital leases | (51,636) | (91,130) |
| Net cash (used in) provided by financing activities | (51,636) | 287,728 |
| Net effect of foreign currency exchange translation on cash | (1,433) | 1,863 |
| Net increase (decrease) in cash and cash equivalents | 1,752,166 | (184,710) |
| Cash and cash equivalents at beginning of period | 2,264,606 | 2,399,717 |
| Cash and cash equivalents at end of period | \$ 4,016,772 | \$ 2,215,007 |

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, | 2009 |
| | 2010 | |
| Cash received (paid) during the period for: | | |
| Interest paid | \$(394,083) | \$(319,716) |
| Interest received | \$27,883 | \$1,007 |
| Foreign income tax paid | \$(48,916) | \$(30,059) |
| Non-cash financing activities: | | |
| Debt waiver, modification fee and interest | \$5,917 | \$225,210 |
| Effect of foreign currency translation on net assets | \$(6,348) | \$4,075 |
| Capital lease obligation | \$- | \$10,494 |

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, 2009. The balance sheet as of December 31, 2009 has been derived from the audited financial statements as of that date but omits certain information and footnotes required for complete financial statements.

The annual consolidated financial statements for the year ended December 31, 2009 were prepared on the basis of a going concern. The Company's independent registered public accounting firm noted significant risks associated with the Company's ability to continue on this basis. The risks were primarily attributable to the uncertainty related to obtaining future liquidity sufficient to fund on-going operations and to satisfy the Company's debt obligations maturing at June 30, 2010. Pursuant to the Recapitalization Agreement entered into on July 30, 2010 (See Note 13 – Subsequent Events) the Company fully satisfied this debt by issuance of preferred stock to the lender. In addition, the amendment of the Company's Loan Agreement makes available additional operating capital sufficient to fund on-going operations for the next twelve months. As a consequence, the risk associated with this debt and with the Company's ability to continue as a going concern has been mitigated subsequent to the date of these 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, 2009, 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Allowance for Accounts and Notes Receivable Doubtful Accounts

The Company is required to make judgments as to the collectability of accounts and notes receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts and notes receivable that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables or note receivable to their net realizable value. The Company records these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on our historical experience, for issues not yet identified. Bad debt expense (recoveries) on accounts receivable for the three and six months ended June 30, 2010 was \$(56,240) and \$73,683, respectively. A recovery of the related party note of \$(275,000) was included in Bad Debt expense for the three and six months ended June 30, 2010, see Note 12 "Related Party Notes and Transactions". Bad debt expense for the three and six months ended June 30, 2009 was \$72,703 and \$77,373, respectively.

Fair Value Measurements

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

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

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

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

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

In accordance with this guidance, the Company measures its cash equivalents at fair value. The Company's cash equivalents are classified within Level 1. Cash equivalents are valued primarily using quoted market prices utilizing market observable inputs. At June 30, 2010 and December 31, 2009, 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 \$1,346,000 and \$495,000, respectively.

Effective January 1, 2009, 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 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.

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, royalty expense, and other sales related costs. Marketing and advertising efforts are expensed as incurred and for the three and six months ended June 30, 2010 were \$12,318 and \$15,828 respectively, compared to \$2,051 and \$29,195 for the three and six months ended June 30, 2009, respectively.

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 and six months ended June 30, 2010 totaled \$903,319 and \$1,619,900, respectively. Interest expense for the three and six months ended June 30, 2009 totaled \$661,826 and \$1,299,045, 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 \$18,499 and \$27,883, respectively, for the three and six months ended June 30, 2010, as compared to \$739 and \$1,007 for the same periods in 2009.

Foreign Currency Translation

The Company has operations and holds assets in various foreign countries. The local currency is the functional currency for the Company 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 other accumulated comprehensive income were a cumulative foreign currency translation gain of \$67,941 and \$74,289 at June 30, 2010 and December 31, 2009, respectively.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Comprehensive income (loss)

Comprehensive income (loss) consists of net income (loss) and unrealized gains on foreign currency translation adjustments. Comprehensive income (loss) and its components for the three and six months ended June 30, 2010 and 2009 is as follows:

| | Three Months ended June 30, | | Six Months ended June 30, | |
|-----------------------------------|--------------------------------|-----------|------------------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income (loss) | \$ 646,676 | \$ 74,855 | \$ (200,967) | \$ (1,103,673) |
| Other comprehensive income (loss) | | | | |
| - foreign currency translation | (3,988) | 7,160 | 6,348 | 4,075 |
| Total comprehensive income(loss) | \$ 642,688 | \$ 82,015 | \$ (194,619) | \$ (1,099,598) |

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 net income (loss) for the periods presented.

Reclassifications

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

Note 3. New Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update 2010-06, "Fair Value Measurements and Disclosures" (Topic 820): Improving Disclosures about Fair Value Measurements. This guidance amends the disclosure requirements related to recurring and nonrecurring fair value measurements and requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance became effective for the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for the reporting period beginning January 1, 2011. The adoption of this updated guidance was not significant to the consolidated financial statements.

In February 2010, the FASB issued updated guidance related to subsequent events. As a result of this updated guidance, public filers must still evaluate subsequent events through the issuance date of their financial statements;

however, they are not required to disclose the date in which subsequent events were evaluated in their financial statements disclosures. This amended guidance became effective upon its issuance on February 24, 2010 at which time the Company adopted this updated guidance.

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 loss per share computations:

| | Net income (loss) (Numerator) | Shares (Denominator) | Per Share Amount |
|-----------------------------------|-------------------------------------|-------------------------|---------------------|
| Three months ended June 30, 2010: | | | |
| Basic net income per share - | | | |
| Applicable to common stockholders | \$ 646,676 | 20,291,433 | \$ 0.03 |
| Effect of Dilutive Securities - | | | |
| Options | - | 674,754 | - |
| Net income to common stockholders | \$ 646,676 | 20,966,187 | \$ 0.03 |
| Three months ended June 30, 2009: | | | |
| Basic net income per share - | | | |
| Applicable to common stockholders | \$ 74,855 | 20,291,433 | \$ 0.01 |
| Effect of Dilutive Securities - | | | |
| Options | - | - | - |
| Net income to common stockholders | \$ 74,855 | 20,291,433 | \$ 0.01 |
| Six months ended June 30, 2010: | | | |
| Basic net loss per share - | | | |
| Applicable to common stockholders | \$ (200,967) | 20,291,433 | \$ (0.01) |
| Effect of Dilutive Securities - | | | |
| Options | - | - | - |
| Net loss to common stockholders | \$ (200,967) | 20,291,433 | \$ (0.01) |
| Six months ended June 30, 2009: | | | |
| Basic net loss per share - | | | |
| Applicable to common stockholders | \$ (1,103,673) | 20,291,433 | \$ (0.05) |
| Effect of Dilutive Securities - | | | |
| Options | - | - | - |
| Net loss to common stockholders | \$ (1,103,673) | 20,291,433 | \$ (0.05) |

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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. Options to purchase 1,955,000 shares of common stock exercisable between \$0.06 and \$0.11 were included in the computation of diluted net income per share 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 not included in the computation of diluted net income (loss) per share because exercise or conversion would have an antidilutive effect on the net loss per share.

Warrants to purchase 318,495 shares of common stock exercisable at \$3.65 and options to purchase 5,398,100 shares of common stock exercisable between \$0.11 and \$5.23, were outstanding for the three and six months ended June 30, 2009, but were not included in the computation of diluted net income (loss) per share because the effect of exercise or conversion would have an antidilutive effect on net income (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, 2010 and December 31, 2009 was \$160,001 and \$232,329, respectively.

Note 6. Inventories

Inventories are stated at the lower of cost, determined using the first-in, first-out (“FIFO”) 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, 2010 | December 31, 2009 |
|----------------|------------------|----------------------|
| Finished goods | \$ 2,642,270 | \$ 2,863,923 |
| Less reserves | (1,107,919) | (1,184,621) |

| | | | | |
|-------------------|----|-----------|----|-----------|
| Total inventories | \$ | 1,534,351 | \$ | 1,679,302 |
|-------------------|----|-----------|----|-----------|

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 7. Debt Facility

On June 27, 2007, the Company entered into a Revolving Credit and Term Loan Agreement (the "Loan Agreement") with Bluefin Capital, LLC that provides for a \$5.0 million revolving credit loan and a \$9.5 million term loan for a three year period ending June 30, 2010, which was subsequently extended to July 30, 2010. Bluefin Capital subsequently assigned its rights and obligations under the Loan Agreement to an affiliate, CVC California, LLC. The revolving credit portion of the Loan Agreement permitted borrowings based upon a formula including 85% of the Company's eligible receivables and 55% of eligible inventory, and provided for monthly interest payments at the prime rate (3.25% at June 30, 2010) plus 2.0%. The term loan bears interest at 8.5% annually with quarterly interest payments and repayment in full at maturity. Borrowings under the Loan Agreement are secured by all of the assets of the Company.

In connection with the Loan Agreement, the Company issued 1,500,000 shares of common stock to the lender for \$0.001 per share, and issued warrants to purchase 2,100,000 shares of common stock. The warrants were exercisable over a five-year period and initially 700,000 warrants were exercisable at \$0.95 per share; 700,000 warrants were exercisable at \$1.05 per share; and 700,000 warrants were exercisable at \$1.14 per share. The warrants did not require cash settlements. The relative fair value of the equity (\$2,374,169, which includes a reduction for financing costs) issued with this debt facility was allocated to paid-in-capital and reflected as a debt discount to the face value of the term note.

This discount was amortized over the term of the note and recognized as additional interest cost as amortized. Costs associated with the debt facility included debt fees, commitment fees, registration fees and legal and professional fees of \$486,000. Unamortized costs allocable to the Loan Agreement are reflected as a reduction to the face value of the note on the balance sheet. At June 30, 2010, the discount was fully amortized.

On November 19, 2007, the Company entered into an amendment to the Loan Agreement to modify the original financial covenants and to extend until June 30, 2008 the application of the original EBITDA covenant in exchange for additional common stock of the Company and a price adjustment to the outstanding warrants issued to the lender in connection with the loan agreement. In connection with this amendment the Company issued an additional 250,000 shares of common stock to the lender for \$0.001 per share, and the exercise price for all of the previously issued warrants for the purchase of 2,100,000 shares of common stock was amended to an exercise price of \$0.75 per share. The new relative fair value of the equity issued with this debt of \$2,430,000, including the modifications in this amendment and a reduction for financing costs, was amortized over the term of the note.

On April 3, 2008, the Company executed a further amendment to the Loan Agreement. The amendment included a redefining of the EBITDA covenants, and the cancellation of the common stock warrants previously issued to the lender in exchange for the issuance by the Company of an additional note payable to CVC for \$1.0 million. The note bears interest at 8.5% and both the note and accrued interest are payable at maturity on June 30, 2010. In addition, the Company's borrowing base was modified in this amendment by increasing the allowable portion of inventory held by third party vendors to \$1.0 million with no more than \$500,000 held at any one vendor and increasing the percentage of accounts receivable to be included in the borrowing base to 85%. The Company incurred a one-time modification fee of \$145,000 to secure the amendment. The new relative fair value of the equity issued with this debt of

\$2,542,000, including the modifications in this amendment and a reduction for financing costs, was amortized over the term of the note.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

In connection with the April 2008 amendment the Company evaluated the Loan Agreement amendment under ASC 470-50, "Debt - Modifications and Extinguishments". It was determined that the amendment did not constitute a material change as defined by ASC 470-50 and did not qualify for treatment as a troubled debt restructuring. Accordingly, the Company recorded a reduction to equity and an increase to notes payable for the fair value of the warrants of \$260,205 and the difference (\$739,795) between the fair value of the warrants at the time of repurchase and the face value of the note was recorded as an additional deferred cost and is reflected as a reduction to the face value of the note on the balance sheet. This cost has been amortized using the interest-method over the life of the modified notes and is 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) in excess of the principal and interest payments for the same period of not less than \$1.00 and in excess of ratios set out in the agreement for each quarter.

The Company failed to satisfy the minimum EBITDA requirement for quarter ended December 31, 2008 as well as the quarter ended March 31, 2009, and in connection with such failures, on March 31, 2009 the Company entered into a further amendment to the Loan Agreement with CVC.

This amendment provided for the issuance of an additional term note to CVC in the principal amount of \$225,210 in lieu of paying a cash waiver fee in connection with the Company's failures to satisfy the EBITDA requirement for the quarters ended December 31, 2008 and March 31, 2009; deferral of the term note quarterly interest payment of \$215,000 due April 1, 2009; a temporary increase to the borrowing base formulas and calculations under the revolving credit facility; the re-lending by CVC of \$125,000 under the term loan portion of credit facility; a consent to allow the Company to sell equipment that has been designated as held for sale; and the granting to CVC of the right to designate a non-voting observer to attend all meetings of the Company's Board of Directors.

The Company was not in compliance with the minimum EBITDA requirement of the Loan Agreement for the quarter ended March 31, 2010. The Company did not pay the waiver fee available in the Loan Agreement to waive the non-compliance at March 31, 2010 within the timeline established in the Loan Agreement. Accordingly, the unresolved non-compliance constituted an Event of Default under the Loan Agreement.

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

On July 30, 2010, the Company entered into a Recapitalization Agreement (the "Recapitalization Agreement") with CVC in which the Company issued to CVC Series B Convertible Preferred Stock in payment of all of the outstanding obligations owed by the Company to CVC under the Loan Agreement. See Note 13.

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In connection with the Recapitalization Agreement, on July 30, 2010 the Company amended the Loan Agreement to extend the maturity date of the Loan Agreement from July 30, 2010 until July 31, 2012, reduced the “Maximum Revolver Amount” to \$3,000,000, amended the “Borrowing Base” to provide that the advance rate applicable to Eligible Accounts is modified to 75% and the advance rate applicable to Eligible Inventory is modified to 40%, eliminated loan maintenance fees, and modified 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. Upon execution of the amendment, CVC waived all prior Events of Default under the Loan Agreement.

As of June 30, 2010, the Company had outstanding borrowings and accrued interest of \$11,444,421 under the term notes, and \$5,096,424 under the revolving credit note, all of which was exchanged for the Series B Convertible Preferred Stock on July 30, 2010. Consequently the outstanding amounts under the Loan Agreement at June 30, 2010 are presented as part of long term liabilities in the consolidated balance sheet.

Interest expense related to the Revolving Credit and Term Loan Agreement for the three and six months ended June 30, 2010 was \$891,210 and \$1,597,082, respectively, which includes \$436,615 and \$849,096, respectively in amortization of discounts and deferred financing costs.

Interest expense related to the Revolving Credit and Term Loan Agreement for the three and six months ended June 30, 2009 was \$652,400 and \$1,275,880, respectively, which includes \$357,239 and \$699,340 in amortization of discounts and deferred financing costs for the same periods.

Note 8. Stock-Based Compensation

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

On July 14, 2008, at the Company’s annual meeting of stockholders, the 2008 Stock Plan was approved by the stockholders. The 2008 Stock Plan authorizes up to 2,500,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. On July 31, 2007, at the Company’s annual meeting of stockholders, the 2007 Stock Plan was approved which replaced the 1997 Stock Plan.

The 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. Options granted to certain employees in 2008 include certain vesting acceleration features based on Company performance as determined by the Board of Directors each year. Consistent with ASC 718-10, the stock based compensation expense for the employee options are recognized on a time-phased vesting schedule through the vesting date of December 31, 2010. In calculating the outcome of meeting performance conditions for

2009, the Company exceeded the performance criteria and accordingly, accelerated vesting was applied to the eligible stock options. No options were granted for the three and six months ended June 30, 2010 and 2009.

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As of June 30, 2010, the Company had \$98,342 of unamortized stock-based compensation expense related to options issued to employees and directors, which will be recognized over the weighted average period of 1.5 years. As of June 30, 2009, unamortized stock-based compensation expense related to options issued to employees and directors was approximately \$318, 885, which is being recognized over the weighted average period of approximately 1.7 years.

The following table summarizes the activity in the Company's share based plans during the six months ended June 30, 2010.

| | Number of Shares | Weighted Average Exercise Price |
|---------------------------------------|---------------------|---------------------------------------|
| Employees and Directors | | |
| Options outstanding - January 1, 2010 | 6,637,850 | \$ 0.73 |
| Granted | - | \$ - |
| Exercised | - | \$ - |
| Cancelled | (66,479) | \$ 4.55 |
| Options outstanding - March 31, 2010 | 6,571,371 | \$ 0.69 |
| Granted | - | \$ - |
| Exercised | - | \$ - |
| Cancelled | (147,771) | \$ 1.88 |
| Options outstanding - June 30, 2010 | 6,423,600 | \$ 0.66 |

Note 9. Income taxes

The Company accrues interest and penalties related to unrecognized tax benefits in interest and penalties expense. For the three and six months ended June 30, 2010 and 2009, the Company accrued interest and penalties for unrecognized tax benefits of \$3,975 and \$7,950, respectively. At June 30, 2010 and December 31, 2009, the Company had approximately \$85,575 and \$77,625, respectively, accrued in interest and penalties associated with the unrecognized tax liabilities.

Deferred tax assets were \$89,564 at December 31, 2009, related to the Company's foreign operations and were 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, has been recorded since 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 \$21,464 and \$10,151 as of June 30, 2010 and December 31, 2009, respectively, and were included in other accrued expenses. As of June 30, 2010 and December 31, 2009 prepaid income tax totaled \$24,359 and \$5,527, respectively.

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Note 10. 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 a number of 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, after taking into account the insurance in place, 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:

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.

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Note 11. Segment Reporting and Geographic Information

The Company manufactures and distributes a full range of zipper, trim and waistband items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. Our organization is based on divisions representing the major product lines, and our 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 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 |

| | Three Months Ended June 30, 2009 | | | |
|------------------------|-------------------------------------|--------------|-----------|---------------|
| | Talon | Trim | Tekfit | Consolidated |
| Net sales | \$ 7,696,659 | \$ 4,863,876 | \$ 23,230 | \$ 12,583,765 |
| Cost of goods sold | 5,939,552 | 3,072,342 | 10,424 | 9,022,318 |
| Gross profit | \$ 1,757,107 | \$ 1,791,534 | \$ 12,806 | 3,561,447 |
| Operating expenses | | | | 2,729,402 |
| Income from operations | | | | \$ 832,045 |

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| | Six Months Ended 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 | \$ 3,748,055 | \$ 3,093,126 | \$ (65,251) | 6,775,930 |
| Operating expenses | | | | 5,253,863 |
| Income from operations | | | | \$ 1,522,067 |

| | Six Months Ended June 30, 2009 | | | |
|------------------------|-----------------------------------|--------------|-----------|---------------|
| | Talon | Trim | Tekfit | Consolidated |
| Net sales | \$ 11,028,352 | \$ 8,034,062 | \$ 37,105 | \$ 19,099,519 |
| Cost of goods sold | 8,462,280 | 5,073,727 | 17,898 | 13,553,905 |
| Gross profit | \$ 2,566,072 | \$ 2,960,335 | \$ 19,207 | 5,545,614 |
| Operating expenses | | | | 5,248,739 |
| Income from operations | | | | \$ 296,875 |

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, intangible assets and property held for sale) is attributed to countries based on the location of the assets, as follows:

| Sales: Country / Region | Three Months ended June 30, | | Six Months ended June 30, | |
|----------------------------|--------------------------------|---------------|------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| United States | \$ 1,201,996 | \$ 919,777 | \$ 2,007,615 | \$ 1,569,610 |
| Hong Kong | 4,752,797 | 3,064,825 | 7,974,739 | 5,482,757 |
| China | 4,556,589 | 4,458,898 | 6,091,380 | 5,622,462 |
| Taiwan | 785,073 | 391,556 | 936,111 | 495,552 |
| Bangladesh | 706,696 | 596,128 | 1,387,299 | 1,140,413 |
| India | 300,809 | 486,631 | 533,195 | 824,436 |
| Other | 2,669,112 | 2,665,950 | 4,277,993 | 3,964,289 |
| Total | \$ 14,973,072 | \$ 12,583,765 | \$ 23,208,332 | \$ 19,099,519 |

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| | June 30, 2010 | December 31, 2009 |
|--------------------|------------------|----------------------|
| Long-lived Assets: | | |
| United States | \$ 4,721,546 | \$ 4,661,855 |
| Hong Kong | 1,010,337 | 1,193,617 |
| China | 209,069 | 236,768 |
| Other | 3,185 | 4,097 |
| Total | \$ 5,944,137 | \$ 6,096,337 |

Note 12. Related Party Notes and Transactions

Colin Dyne, a former director and stockholder of the Company is also a director, officer and significant stockholder of People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. and 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. During the three and six months ended June 30, 2009 the Company had sales of \$77,500 and \$123,700, respectively, to William Rast Sourcing. Accounts receivable of \$60,909 and \$41,200 were outstanding from William Rast Sourcing at June 30, 2010 and December 31, 2009, respectively.

Note Receivable from Related Party, net at December 31, 2009 represents the unsecured note and accrued interest receivable due from Colin Dyne in the amount of \$720,417, and included a valuation reserve for the full amount due. The note bore interest at 7.5% and was due on demand. On June 29, 2010, the Company sold the Note Receivable with all of the Company's rights, title and interest therein to a third party for cash proceeds of \$275,000. The amount received was recorded as recovery of bad debts.

In November 2009, the Company entered into an agreement to pay a commission to an affiliate of Colin Dyne of 7% of collected revenues associated with the sales of selected business opportunities, with 2% of the 7% earned applied to the note receivable balance. For the three and six months ended June 30, 2010 commissions of \$34,155 and \$55,540 were paid in cash, respectively. For the three and six months ended June 30, 2009 \$17,679 and \$27,057, respectively were applied to the note receivable balance.

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, 2010 and December 31, 2009 was \$232,902 and \$229,356, respectively.

Consulting fees and related interest expenses to Diversified Consulting, LLC, a company owned by Mark Dyne, amounted to \$5,367 and \$54,536 for the three and six months ended June 30, 2010, respectively. Consulting fees paid for the three and six months ended June 30, 2009 were \$37,500 and \$75,000, respectively. This consulting arrangement terminated on March 20, 2010. As of June 30, 2010 and December 31, 2009 accrued expenses includes

consulting fees and associated interest in the amount of \$231,104 and \$251,568 due to Diversified Consulting, LLC.

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Notes payable to related parties also includes a note and associated interest due to Lonnie D. Schnell, the Chief Executive Officer and Chief Financial Officer of the Company. This note, issued on August 6, 2009 in partial satisfaction of 2008 annual incentive amounts 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, 2010 and December 31, 2009 was \$37,625 and \$36,516, respectively.

Note 13. Subsequent Events

The Company evaluated subsequent events after the balance sheet date of June 30, 2010 through the date these unaudited financial statements were issued. The complete impact of these subsequent events for recording during the Third Quarter 2010 is currently being evaluated.

Recapitalization Agreement

On July 30, 2010, the Company entered into a Recapitalization Agreement with CVC, pursuant to which the Company issued to CVC an aggregate of 407,160 shares of a newly created series of the Company's preferred stock, designated Series B Convertible Preferred Stock, \$0.001 par value per share (the "Series B Preferred Stock"), in payment of an aggregate of approximately \$16.7 million 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.

In connection with the Recapitalization Agreement the Company and CVC released all claims each may have against the other of any kind or nature arising out of or related to the Loan Agreement and the other loan documents which may have arisen on or before the date of the Recapitalization Agreement.

Series B Preferred Stock

On July 30, 2010, the Company amended its certificate of incorporation by creating a new series of preferred stock designated Series B Convertible Preferred Stock, \$0.001 par value per share. The rights, preferences, privileges and restrictions of the Series B Preferred Stock, include the following:

- The Series B Preferred Stock ranks senior to our 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.
- The Series B Preferred Stock will accrue dividends at the rate of 16% per annum, compounded annually, which dividends may only be paid upon liquidation, dissolution or winding up of the Company. Unpaid accrued dividends will not be convertible into common stock, nor will any unpaid accrued dividends be payable on shares of Series B Preferred Stock following the conversion of such shares into common stock.

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- Upon the liquidation, dissolution or winding up of the Company, each Series B Share will be entitled to receive, prior to any distribution to holders of other equity securities, an amount equal to \$41.033 per share plus all unpaid accrued dividends on such share. After this liquidation preference has been paid in full, any remaining amounts available for distribution shall be payable to the holders of junior securities (including common stock) in the applicable order of priority. 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, shall be deemed a liquidation and winding up for purposes of the Company's obligation to pay the liquidation preference.
- 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.
- 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.
- The Series B Preferred Stock will 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 Series B Share 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 shall 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.
- Additionally, so long as the outstanding Series B Preferred Stock represents at least 35% of the voting shares of the Company, on an as-converted to common stock basis, (a) our Board of Directors shall consist of not more than seven (7) members, (b) the holders of Series B Preferred Stock shall have the right to elect three (3) directors if the Board has five (5) or fewer total directors, and four (4) directors if the Board has six (6) or seven (7) 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 elect all remaining directors. At least two (2) 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 our 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.

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Stockholders Agreement

Concurrently with execution of the Recapitalization Agreement, on July 30, 2010, the Company entered into a Stockholders Agreement with CVC, Lonnie D. Schnell, the Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors, and Larry Dyne, the President, 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.
- 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.

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- 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 each of Messrs. Schnell and Dyne a portion (beginning at 5% each and increasing to 10% each) 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 the respective employment agreements).

Change in Board of Directors

In connection with the Recapitalization Agreement, on July 30, 2010, each of Messrs. Brent Cohen, Colin Dyne, Raymond Musci and Joseph Miller resigned from the Company's Board of Directors, Mark Dyne and Lonnie Schnell remain on the Board of Directors, and Michael Snyder and Mark Hughes were appointed to the Board of Directors to fill two of the vacancies caused by such resignations. Messrs. Snyder and Hughes were designated by CVC for appointment to the Board, and will serve as Series B Directors.

The Company agreed to file with the Securities and Exchange Commission, and distribute to stockholders, an Information Statement on Schedule 14f-1, disclosing the intention to appoint a third CVC designee to the Board of Directors promptly following the identification of that director designee by CVC, and to appoint such additional designee to the Board of Directors after the requisite waiting period has elapsed under Section 14f-1 of the Securities Exchange Act of 1934. Following the appointment of the third CVC designee to the Board of Directors, the Board of Directors will consist of five members, three of which will have been appointed by CVC and will serve as Series B Directors.

The Company agreed to seek stockholder approval of an amendment to the certificate of incorporation to eliminate the provisions thereof requiring a classified Board of Directors, and to promptly file such amendment after obtaining such stockholder approval. In addition the Company agreed to pay to CVC a monitoring fee of \$5,000 per month until such time as the Series B Preferred Stock shall no longer entitle the holders thereof, voting as a separate class, to elect directors to serve on the Board of Directors.

Executive Employment Agreements & Option Plans

On July 30, 2010 the Company entered into an Executive Employment Agreement with each of Lonnie D. Schnell, our Chief Executive Officer and Chief Financial Officer, and Larry Dyne, our President, and terminated Messrs. Schnell and Dyne's existing Executive Employment Agreements, both dated June 18, 2008.

Mr. Schnell's Executive Employment Agreement provides that he will continue to serve as the Company's Chief Executive Officer. The employment agreement has a term continuing through December 31, 2013, which term may be extended to December 31, 2014. Mr. Schnell will be entitled to receive an annual cash bonus in an amount equal to a percentage of his base salary upon the Company achieving actual adjusted EBITDA within a range, starting at 80%, of target adjusted EBITDA. Mr. Schnell is entitled to reimbursement of up to \$10,000 for legal fees incurred in

connection with the negotiation of his employment agreement.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

In the event that Mr. Schnell's employment is terminated by the Company without cause or by Mr. Schnell for good reason (as defined in the agreement) or due to Mr. Schnell's death or disability, then conditional upon his execution of a release of claims, Mr. Schnell or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to 18 months of Mr. Schnell's base salary, (ii) if the termination occurs prior to August 30, 2011, then 50% of the RSU Award (as described below) will vest as of the date of termination, (iii) all options issued to Mr. Schnell shall remain outstanding for 18 months following termination, and (iv) continued medical coverage for Mr. Schnell and his dependents for 18 months following termination.

Mr. Dyne's Executive Employment Agreement provides that he will continue to serve as the Company's President. The employment agreement has a term continuing through December 31, 2013, which term may be extended to December 31, 2014. Mr. Dyne will be entitled to receive an annual cash bonus in an amount equal to a percentage of his base salary upon the Company achieving actual adjusted EBITDA within a range, starting at 80%, of target adjusted EBITDA. Mr. Dyne is entitled to reimbursement of up to \$10,000 for legal fees incurred in connection with the negotiation of his employment agreement. In the event that Mr. Dyne's employment is terminated by the Company without cause or by Mr. Dyne for good reason (as defined in the agreement) or due to Mr. Dyne's death or disability, then conditional upon his execution of a release of claims, Mr. Dyne or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to 18 months of Mr. Dyne's base salary, (ii) if the termination occurs prior to August 30, 2011, then 50% of the RSU Award (as described below) will vest as of the date of termination, (iii) all options issued to Mr. Dyne shall remain outstanding for 18 months following termination, and (iv) continued medical coverage for Mr. Dyne and his dependents for 18 months following termination.

Upon entering into the employment agreements, each of Messrs. Schnell and Dyne were awarded a restricted stock unit award (an "RSU Award"), for 5,778,500 shares of the Company's common stock, which RSU Award shall 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 defined in the RSU Award agreement. Upon entering into the employment agreements, each of Messrs. Schnell and Dyne agreed to cancel all options to purchase shares of the Company's common stock previously awarded to such executive on or before December 31, 2007, and such options were cancelled effective July 30, 2010.

On July 29, 2010, our Board of Directors approved an amendment to the Company's 2008 Stock Incentive Plan (the "Plan Amendment") to increase by 2,310,000 the number of shares of common stock that may be issued pursuant to awards thereunder. The Plan Amendment is conditional upon approval of the Plan Amendment by our stockholders.

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 consolidated financial statements. This management's discussion and analysis is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and accompanying notes.

Talon International, Inc. designs, sells, manufactures 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 Talon zippers through the establishment of Talon owned sales, distribution and manufacturing locations, strategic distribution relationships and joint ventures. These distributors and manufacturing joint ventures, in combination with Talon owned and affiliated facilities under the Talon brand, improve our time-to-market by eliminating the typical setup and build-out phase for new manufacturing capacity throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets.

We have structured our trim business to focus as an outsourced product development, sourcing and sampling department for the most demanding brands and retailers. We believe that trim design differentiation among brands and retailers has become a critical marketing tool for our customers. By assisting our customers in the design, development, sampling and sourcing of trim, we expect to achieve higher margins for our trim products, create long-term relationships with our customers, grow our sales to a particular customer by supplying trim for a larger proportion of their brands and better differentiate our trim sales and services from those of our competitors. We are expanding our trim business globally, so we may better serve our apparel factory customers in the field, in addition to our brand and retail customer. We believe we can lead the industry in trim sourcing by having both an intimate relationship with our brand and retail customers and having a distributed service organization to serve our factory customers (those that manufacture for the apparel brand and retailers) globally.

Our Tekfit business provides manufacturers with the patented technology, manufacturing know-how and materials required to produce pants incorporating an expandable waistband. Our efforts to expand this product offering to other customers have been limited by a licensing dispute. As described more fully in this report under Item 1. "Legal Proceedings", we are presently 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. The revenues we derive from the sale of products incorporating the stretch waistband technology represented less than 1% of our consolidated revenues for the three and six month ended June 30, 2010 and 2009. Our business prospects for this group could be adversely affected if our dispute with Pro-Fit is not resolved in a manner favorable to us.

Effects of the Global Economic Recession

During 2009, we experienced a general decrease in sales which reflected the impact of the global recession on the apparel industry and the corresponding lower demand for all apparel products including our Talon zipper and trims products. The apparel industry and our customers were expected to continue to be adversely impacted by this recession in 2010 and perhaps beyond, depending upon the global economic trends. During year 2009 and first half of 2010 year-to-year comparative sales performance by quarter with prior years reflected improvements throughout the periods after the sharp retail industry decline that began late in 2008. The sales during the second quarter of 2010 reflected a sales increase from the same quarter in 2009 by 19% while the second quarter of 2009 reflected a sales decline from the same period in 2008 by more than 26%. The sales during the first half of 2010 reflected a sales increase from the same period in 2009 by 22% while the first half of 2009 reflected a sales decline from the same period in 2008 by more than 29%.

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 | | Six Months ended | | | | | |
|--|--------------------|------|------------------|------|-------|------|-------|----|
| | June 30, | | June 30, | | 2009 | | | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | | |
| Net sales | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |
| Cost of goods sold | 71.0 | | 71.7 | | 70.8 | | 71.0 | |
| Gross profit | 29.0 | | 28.3 | | 29.2 | | 29.0 | |
| Sales and marketing expenses | 5.3 | | 5.7 | | 6.2 | | 7.4 | |
| General and administrative expenses | 12.4 | | 16.0 | | 16.4 | | 20.1 | |
| Interest expense, net and income taxes | 7.0 | | 6.0 | | 7.5 | | 7.3 | |
| Net income (loss) | 4.3 | % | 0.6 | % | (0.9) |)% | (5.8) |)% |

Sales

For the three and six months ended June 30, 2010 and 2009, sales by geographic region based on the location of the customer as a percentage of sales were as follows:

| Region | Three Months ended June 30, | | | | Six Months ended June 30, | | | |
|---------------|--------------------------------|---|-------|---|------------------------------|---|-------|---|
| | 2010 | | 2009 | | 2010 | | 2009 | |
| United States | 8.0 | % | 7.3 | % | 8.7 | % | 8.2 | % |
| Hong Kong | 31.7 | % | 24.4 | % | 34.4 | % | 28.7 | % |
| China | 30.4 | % | 35.4 | % | 26.2 | % | 29.4 | % |
| Taiwan | 5.2 | % | 3.1 | % | 4.0 | % | 2.6 | % |
| Bangladesh | 4.7 | % | 4.7 | % | 6.0 | % | 6.0 | % |
| India | 2.0 | % | 3.9 | % | 2.3 | % | 4.3 | % |
| Other | 18.0 | % | 21.2 | % | 18.4 | % | 20.8 | % |
| | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |

Sales for the three months ended June 30, 2010 were \$15.0 million, an increase of \$2.4 million or 19.0%, from the same period in 2009. Sales for the six months ended June 30, 2010 were \$23.2 million, an increase of \$4.1 million or 21.5%, from the same period in 2009. The net increase reflects improved worldwide economic conditions for Talon's customers in the apparel industry and the higher demand for our Talon zipper products, and the addition of new products and customers.

Gross Profit

Gross profit for the three months ended June 30, 2010 was \$4.3 million as compared to \$3.6 million for the same period in 2009. The increase in gross profit for the three months ended June 30, 2010 as compared to the same period in 2009 was principally attributable to higher overall sales volumes and improved product mix, partially offset by higher contract services costs associated with quality control and product development and higher inventory obsolescence.

Gross profit for the six months ended June 30, 2010 was \$6.8 million as compared to \$5.5 million for the same period in 2009. The increase in gross profit for the six months ended June 30, 2010 as compared to the same period in 2009 was principally attributable to higher overall sales volumes, partially offset by a less favorable mix, higher contract services costs for quality control and product development and higher inventory obsolescence.

A recap of the change in gross margin for the three and six months ended June 30, 2010 as compared with the same period in 2009 is as follows:

| | Three Months ended June 30, 2010 compared to same period in 2009 \$ in 000's | | Six Months ended June 30, 2010 compared to same period in 2009 \$ in 000's | |
|--|--|-------|--|--------|
| | (1) | % (1) | (1) | % (1) |
| Gross profit increased as a result of: | | | | |
| Higher volumes | 879 | 24.7 | 1,565 | 28.1 |
| Mix of products | 23 | 0.6 | (97) | (1.8) |

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| | | | | |
|---|-------|--------|--------|--------|
| Increased freight and duty costs | (71) | (2.0) | (23) | (0.4) |
| Increased contract services and inventory obsolescence | (53) | (1.4) | (215) | (3.8) |
| Gross profit increase | 778 | 21.9 | 1,230 | 22.1 |

(1) Represents the amount or percentage, as applicable, change in each item in the three and six months ended June 30, 2010 period, as compared to the same period in 2009.

Sales and marketing expenses

Sales and marketing expenses for the three months ended June 30, 2010 were \$0.8 million, or 5.3% of sales, as compared to \$0.7 million, or 5.7% of sales, for the same period in 2009. Sales and marketing expenses for the six months ended June 30, 2010 were \$1.4 million, or 6.2% of sales, as compared to \$1.4 million, or 7.4% of sales, for the same period in 2009. Sales expenses decreased as a percentage of sales primarily due to lower sales force expenses in Asia.

General and administrative expenses

General and administrative expenses for the three months ended June 30, 2010 were \$1.9 million, or 12.4% of sales, as compared with \$2.0 million, or 16.0% of sales, for the same period in 2009. General and administrative expenses for the six months ended June 30, 2010 were \$3.8 million, or 16.4% of sales, as compared with \$3.8 million, or 20.1% of sales, for the same period in 2009. The decreases mainly reflect the beneficial effect of the sale of the Note Receivable from Related party for \$275,000 and other reductions to the allowance for doubtful accounts. These costs reductions were substantially offset by increased employee expenses associated with greater sales volumes.

Interest expense and interest income

Interest expense for the three months ended June 30, 2010 increased by approximately \$241,000, as compared to the same period in 2009, to \$903,000. Interest expense for the six months ended June 30, 2010 increased by approximately \$321,000, as compared to the same period in 2009, to \$1,620,000. The increases were due to increased borrowings under our revolving credit and term loan facility, the related amortization of deferred financing costs and debt discounts, and a higher interest rate associated with our event of default at March 31, 2010.

Interest income for the three and six months ended June 30, 2010 increased by approximately \$18,000 and \$27,000, respectively to approximately \$19,000 and \$28,000, respectively due primarily to the recognition of and collection of interest income on a note receivable (See Note 12 in the accompanying Notes to Consolidated Financial Statements).

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

| | Three Months ended June 30, | | Six Months ended June 30, | |
|---|--------------------------------|------------|------------------------------|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| Amortization of deferred financing costs and debt discounts | \$ 436,615 | \$ 357,239 | \$ 849,096 | \$ 699,340 |
| Other interest expense | \$ 466,705 | \$ 304,587 | \$ 770,805 | \$ 599,705 |
| Interest expense | \$ 903,320 | \$ 661,826 | \$ 1,619,901 | \$ 1,299,045 |
| Interest income | \$ (18,499) | \$ (739) | \$ (27,883) | \$ (1,007) |
| Interest expense, net | \$ 884,821 | \$ 661,087 | \$ 1,592,018 | \$ 1,298,038 |

Income taxes

Provision for income taxes for the three and six months ended June 30, 2010 were approximately \$166,000 and \$131,000, respectively. Provision for income taxes for the three and six months ended June 30, 2009 were approximately \$96,000 and \$103,000, respectively. The provision for income taxes is mainly associated with our foreign operations. There is insufficient evidence to determine that it is more likely than not that we will be able to utilize our domestic operating loss carry forwards, and a portion of our foreign net operating loss carry forwards, to offset future taxable income and as a result, the tax benefit of these losses have a full valuation reserve provided against them.

Liquidity and Capital Resources

The following table summarizes selected financial data at:

| | (\$ in thousands) | |
|--|-------------------|----------------------|
| | June 30, 2010 | December 31, 2009 |
| Cash and cash equivalents | \$ 4,017 | \$ 2,265 |
| Total assets | \$ 16,576 | \$ 13,834 |
| Current liabilities | \$ 10,594 | \$ 24,262 |
| Long-term debt, net of current liabilities | \$ 17,255 | \$ 751 |
| Stockholders' deficit | \$ (11,273) | \$ (11,179) |

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

On July 30, 2010, we entered into a Recapitalization Agreement (the "Recapitalization Agreement") with CVC in which we issued to CVC Series B Convertible Preferred Stock in payment of all of the outstanding obligations owed by us to CVC under the Loan Agreement. At the same time, we amended the Loan Agreement to extend the term of the revolving credit facility provided for under the Loan Agreement. See Note 13 in the accompanying Notes to the Consolidated Financial Statements.

Cash and cash equivalents

Cash and cash equivalents increased by approximately \$1,752,000 at June 30, 2010 as compared to December 31, 2009, principally due to net cash provided by operating activities.

Cash provided by operating activities is our primary recurring source of funds, and reflects net income (loss) from operations excluding non cash charges, and changes in operating capital. The six months ended June 30, 2010 reflected net cash provided by operating activities of approximately \$1,826,000. The six months ended June 30, 2009 reflected a net cash used in operating activities of approximately \$57,000.

The net cash provided by (used in) operating activities during the six months ended June 30, 2010 and 2009 resulted principally from:

| | (\$ in thousands) | |
|---|-------------------|----------|
| | Six Months ended | |
| | June 30, | |
| | 2010 | 2009 |
| Net income before non-cash expenses | \$ 1,275 | \$ 131 |
| Inventory reduction | (38) | (266) |
| Increased accounts receivables | (1,182) | (1,632) |
| Increased accounts payable and accrued expense | 2,063 | 1,820 |
| Other reductions in operating capital | (292) | (110) |
| Cash provided by (used in) operating activities | \$ 1,826 | \$ (57) |

Net cash used in investing activities for the six months ended June 30, 2010 and 2009 was approximately \$(21,000) and (\$417,000), respectively. The expenditures in the first six months of 2009 were principally associated with the development of our new ERP system that was implemented in March 2009.

Net cash used in financing activities for the six months ended June 30, 2010 was approximately \$52,000 and reflects repayment of borrowings under capital leases. For the six months ended June 30, 2009 net cash provided by financing activities was approximately \$288,000 and primarily reflects the repayment of borrowings under capital leases and notes payable, net of borrowings under our revolver line of credit and term note.

On June 27, 2007, we entered into a Revolving Credit and Term Loan Agreement (the "Loan Agreement") with Bluefin Capital, LLC that provides for a \$5.0 million revolving credit loan and a \$9.5 million term loan 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 California, LLC ("CVC"). The revolving credit portion of the Loan Agreement, as amended, permits borrowings based upon a formula including 85% of eligible receivables and 55% of eligible inventory and provides for monthly interest payments at the U.S.A. prime rate (3.25% at June 30, 2010) plus 2.0%. The term loan bears interest at 8.5% annually with quarterly interest payments and repayment in full at maturity.

Borrowings under the Loan Agreement are secured by all of our assets. There were no available borrowings at June 30, 2010. At December 31, 2009 our borrowing base (\$4,546,996) was lower than our actual borrowing (\$4,988,988) therefore we did not have available borrowing at that date.

In connection with the Loan Agreement, we issued 1,500,000 shares of common stock to the lender for \$0.001 per share, and issued warrants to purchase 2,100,000 shares of common stock. The warrants were exercisable over a five-year period and initially 700,000 warrants were exercisable at \$0.95 per share; 700,000 warrants were exercisable at \$1.05 per share; and 700,000 warrants were exercisable at \$1.14 per share. The warrants did not require cash settlements. The relative fair value of the equity totaling \$2,374,169 (including a reduction for financing costs) was issued with this debt facility and allocated to paid-in-capital. It was reflected as a debt discount to the face value of the term note.

This discount was amortized over the term of the note and recognized as additional interest cost as amortized. Costs associated with the Loan Agreement included debt fees, commitment fees, registration fees and legal and professional fees of \$486,000. The Unamortized costs allocable to the Loan Agreement are reflected as a reduction to the face value of the note on the balance sheet. At June 30, 2010, the discount was fully amortized.

On November 19, 2007, we entered into an amendment of the Loan Agreement with the lender to modify the original financial covenants and to extend until June 30, 2008 the application of the original EBITDA covenants in exchange for additional common stock and a price adjustment to the lenders outstanding warrants issued to the lender in connection with the Loan Agreement. In connection with this amendment we issued an additional 250,000 shares of common stock to the lender for \$0.001 per share, and the exercise price for all of the previously issued warrants for the purchase of 2,100,000 shares of common stock was amended to an exercise price of \$0.75 per share. The new relative fair value of the equity issued with this debt of \$2,430,000, including the modifications in this amendment and a reduction for financing costs, is being amortized over the term of the note.

On April 3, 2008, we executed a further amendment to the Loan Agreement. The amendment included a redefining of the EBITDA covenants, and the cancellation of the common stock warrants previously issued to the lender in exchange for our issuance of an additional note payable to the lender for \$1.0 million. The note bears interest at 8.5% and both the note and accrued interest are payable at maturity. In addition, our borrowing base was modified in this amendment by increasing the allowable portion of inventory held by third party vendors to \$1.0 million with no more than \$500,000 held at any one vendor and increasing the percentage of accounts receivable to be included in the borrowing base to 85%. We incurred a one-time modification fee of \$145,000 to secure the amendment. The new relative fair value of the equity issued with this debt of \$2,542,000, including the modifications in this amendment and a reduction for financing costs, is being amortized over the term of the note.

Under the terms of the Loan Agreement, as amended, we are 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 we maintain at the end of each fiscal quarter "EBITDA" (as defined in the agreement) in excess of the principal and interest payments for the same period of not less than \$1.00 and in excess of ratios set out in the agreement for each quarter.

We failed to satisfy the minimum EBITDA requirement for the quarter ended December 31, 2008 as well as the quarter ended March 31, 2009, and in connection with such failures, on March 31, 2009 we entered into a further amendment to the Loan agreement with the lender. This amendment provided for the issuance of an additional term note to the lender in the principal amount of \$225,210 in lieu of paying a cash waiver fee in connection with our failures to satisfy the EBITDA requirements for the quarters ended December 31, 2008 and March 31, 2009; deferral of the term note quarterly interest payment of \$215,000 due April 1, 2009; a temporary increase to the borrowing base formulas and calculations under the revolving Loan Agreement; the re-lending by CVC of \$125,000 under the term loan portion of Loan Agreement; a consent to allow us to sell equipment that has been designated as held for sale more fully described in Note 7 in the accompanying Notes to Consolidated Financial Statements; and the granting to the lender of the right to designate a non-voting observer to attend all meetings of our Board of Directors.

We were not in compliance with the minimum EBITDA requirement of the Loan Agreement for the quarter ended March 31, 2010, and we did not pay the waiver fee available in the Loan Agreement to waive the non-compliance within the timeline established in the Loan Agreement. Accordingly, the unresolved non-compliance constituted an Event of Default under the Loan Agreement.

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

On July 30, 2010, we entered into a Recapitalization Agreement with CVC in which we issued to CVC Series B Convertible Preferred Stock in payment of all of the outstanding obligations owed by us to CVC under the Loan Agreement. See Note 14 in the accompanying Notes to Consolidated Financial Statements.

In connection with the Recapitalization Agreement, on July 30, 2010 we amended the Loan Agreement to extend the maturity date of the Loan Agreement from July 30, 2010 until July 31, 2012, reduced the "Maximum Revolver Amount" to \$3,000,000, amended the "Borrowing Base" to provide that the advance rate applicable to Eligible Accounts is modified to 75% and the advance rate applicable to Eligible Inventory is modified to 40%, eliminated loan maintenance fees, and modified the permissible amount of Capital Expenditures we can make in any Fiscal Year. 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.

As of June 30, 2010, we had outstanding borrowings and accrued interest of \$11,444,421 under the term notes, and \$5,096,425 under the revolving credit note, all of which was exchanged for the Series B Convertible Preferred Stock on July 30, 2010. Consequently the outstanding amounts under the Loan Agreement at June 30, 2010 are presented as part of long term liabilities in our consolidated balance sheet.

We financed equipment purchases through notes payable and capital lease obligations expiring through June 2014. The remaining equipment obligations bear interest at rates of 8.0% and 15.4% per annum, and under these obligations, we are required to make monthly payments of principal and interest.

The outstanding balance including accrued interest of our notes payable to related parties at June 30, 2010 and December 31, 2009 was approximately \$271,000 and \$266,000, respectively. Included in this balance are demand notes of \$85,000 which bear interest at 10% (total balance as of June 30, 2010 and December 31, 2009 of approximately \$233,000 and 230,000, 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 \$38,000 and \$36,000, 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. The note is fully presented as part of current liabilities as of June 30, 2010 and December 31, 2009.

We have historically 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 (some of which are backed by U.S. brands and retailers) are substantially all foreign based entities. We are continuing to evaluate non-traditional financing of our foreign assets and equity transactions 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 raise additional capital, or further reduce the scope of our business in order to fully 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 future acquisitions, our borrowing base availability limitations related to eligible accounts receivable and inventories and our expansion into foreign markets. Our need for additional long-term financing includes the integration and expansion of our operations to exploit our rights under our Talon trade name, 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, 2010 and the effects such obligations are expected to have on liquidity and cash flow in future periods:

| Contractual Obligations | Payments Due by Period (\$ in thousands) | | | | | |
|---|--|---------------------|---------------|--------------|------------------|------------------|
| | Total | Less than 1 Year | 1-3 Years | 4-5 Years | After 5 Years | Other (2) |
| Demand notes payable to related parties (1) | \$ 233 | \$ 233 | \$ - | \$ - | \$ - | \$ - |
| Note payable to related party | 38 | 38 | - | - | - | - |
| Capital lease obligations | 35 | 9 | 26 | - | - | - |
| Operating leases | 583 | 413 | 170 | - | - | - |
| Revolver and term notes (2) | 16,541 | - | - | - | - | 16,541 |
| Other notes payable | 62 | 62 | - | - | - | - |
| Total Obligations | \$ 17,492 | \$ 755 | \$ 196 | \$ - | \$ - | \$ 16,541 |

(1) The majority of notes payable to related parties is due on demand with the remainder due and payable on the fifteenth day following the date of delivery of written demand for payment and includes accrued interest payable through June 30, 2010.

(2) The revolver and term notes were exchanged on July 30, 2010 for the issuance of preferred stock, eliminating this future obligation. Accordingly, the amount due at June 30, 2010 has been presented as a long-term liability.

At June 30, 2010 and December 31, 2009, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Related Party Transactions

See Note 12 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 and note 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, 2010 and 2009 are as follows:

| | Three Months ended June 30, | | Six Months ended June 30, | |
|---|--------------------------------|------------|------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Bad debt expenses for accounts receivables | \$ (56,240) | \$ 72,703 | \$ (62,351) | \$ 77,373 |
| Bad debt recoveries for accounts receivable | \$ - | \$ - | \$ (11,332) | \$ - |
| Related party note recovery | \$ (275,000) | \$ - | \$ (275,000) | \$ - |
| Allowance for doubtful accounts, accounts receivables | \$ 160,001 | \$ 189,783 | \$ 160,001 | \$ 189,783 |
| Allowance for doubtful accounts, related party | \$ - | \$ 499,680 | \$ - | \$ 499,680 |

- 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 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. We believe that our estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. See Note 9 in the accompanying Notes to Consolidated Financial Statements.
- We record impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition.

The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy may cause us to reassess the carrying amount of our long-lived assets.

- 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.

New Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update 2010-06, "Fair Value Measurements and Disclosures" (Topic 820): Improving Disclosures about Fair Value Measurements. This guidance amends the disclosure requirements related to recurring and nonrecurring fair value measurements and requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance became effective for the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for the reporting period beginning January 1, 2011. The adoption of this updated guidance was not significant to the consolidated financial statements.

In February 2010, the FASB issued updated guidance related to subsequent events. As a result of this updated guidance, public filers must still evaluate subsequent events through the issuance date of their financial statements; however, they are not required to disclose the date in which subsequent events were evaluated in their financial statements disclosures. This amended guidance became effective upon its issuance on February 24, 2010 at which time we adopted this updated guidance.

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, 2010, 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, after taking into account the insurance in place, 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, 2009. Except as set forth below, no material change to such risk factors has occurred during the six months ended June 30, 2010.

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

With our entry into the Recapitalization Agreement on July 30, 2010, we issued to CVC Series B Convertible Preferred Stock which upon conversion, when combined with the 1,750,000 shares of common stock already owned by CVC and/or its affiliates, represents 54.1% of the fully diluted number of shares of common stock and 69.6% of Talon's outstanding voting securities immediately after the issuance of the Series B shares. In addition the holders of Series B Preferred Stock have the right to elect a majority of our Board of Directors. As a result, CVC has the voting power to determine the outcome of virtually any matter submitted to a vote of the holders of our common stock, including the election of a majority of the members of our Board of Directors and any change in control transaction. This concentration of ownership of our voting securities could have the effect of delaying or preventing a change of control of Talon or otherwise discouraging or preventing a potential acquirer from attempting to obtain control of our company. This, in turn, could have a negative effect on the market price of our common stock.

Item 5. Other Information

The Company has determined to delay its 2010 Annual Meeting of Stockholders and has not yet established a record date or meeting date for the Annual Meeting. The Company will disclose the record date and meeting date after they are determined by the Board of Directors.

Item 6. Exhibits

Exhibit No. Description

- | | |
|-------|---|
| 3.1 | Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto. |
| 3.1.2 | Certificate of Designation of Rights, Preferences and Privileges of Series A Preferred Stock. Incorporated by reference to Exhibit A to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. |
| 3.1.3 | Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.4 to Annual Report on Form 10-KSB, filed March 28, 2000. |
| 3.1.4 | Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1.3 to Form 8-K filed on August 4, 2006. |
| 3.1.5 | Certificate of Ownership and Merger. Incorporated by reference to Exhibit 3.1 to Form 8-K filed on July 20, 2007. |
| 3.1.6 | Certificate of Designation of Series B Convertible Preferred Stock. Incorporated by reference to Exhibit 3.1 to Form 8-K filed on August 5, 2010. |
| 10.1 | Recapitalization Agreement, dated June 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on August 5, 2010. |
| 10.2 | Amendment No. 5 to Loan Agreement, dated June 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.2 to Form 8-K filed on August 5, 2010. |
| 10.3 | Amendment No. 6 to Loan Agreement, dated July 30, 2010, between Registrant and CVC California, LLC. Incorporated by reference to Exhibit 10.3 to Form 8-K filed on August 5, 2010. |

- 10.4 Amended and Restated Revolving Credit Note, dated July 30, 2010, made by Registrant in favor of CVC California, LLC. Incorporated by reference to Exhibit 10.4 to Form 8-K filed on August 5, 2010.
- 10.5 Stockholders Agreement, dated July 30, 2010, among Registration, CVC California, LLC, Lonnie D. Schnell and Larry Dyne. Incorporated by reference to Exhibit 10.5 to Form 8-K filed on August 5, 2010.
- 10.6+* Employment Agreement, dated July 30, 2010, between Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.6 to Form 8-K filed on August 5, 2010.
- 10.7+* Employment Agreement, dated July 30, 2010, between Registrant and Larry Dyne. Incorporated by reference to Exhibit 10.7 to Form 8-K filed on August 5, 2010.

Exhibit No. Description

| | |
|-------|--|
| 10.8+ | Restricted Stock Unit Agreement, dated July 30, 2010, between Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.8 to Form 8-K filed on August 5, 2010. |
| 10.9+ | Restricted Stock Unit Agreement, dated July 30, 2010, between Registrant and Larry Dyne. Incorporated by reference to Exhibit 10.9 to Form 8-K filed on August 5, 2010. |
| 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. |

+Indicates a management contract or compensatory plan or arrangement.

*Certain portions of this agreement have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for an order granting confidential treatment pursuant to Rule 24b-2 of the Rules and Regulations under the Securities Exchange Act of 1934, as amended.

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.

Dated: August 12, 2010

/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)

