KONDIK CONNIE
Form 4
October 05, 2009

FORM 4

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

OMB APPROVAL

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
KONDIK CONNIE

(Last) (First) (Middle)

1901 CAPITAL PKWY

(Street)

AUSTIN, TX 78746

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
EZCORP INC [EZPW]

3. Date of Earliest Transaction (Month/Day/Year)
10/01/2009

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Vice-President & Secretary

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Class A Non-Voting Common Stock	10/01/2009		A		3,000 (1)	A	(2)	14,500 (3)	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
KONDIK CONNIE 1901 CAPITAL PKWY AUSTIN, TX 78746			Vice-President & Secretary	

Signatures

/s/ Laura Jones Attorney-in-Fact	10/05/2009
**Signature of Reporting Person	Date

Explanation of Responses:

*	If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).
**	Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
(1)	This Restricted Stock Award is issued with a 3 year "cliff" vesting.
(2)	Closing market value on date of award is $13.17. However, no consideration was paid for the award other than services rendered and to be rendered by the Reporting Person.
(3)	The Total Non-Derivative Securities Beneficially Owned includes 14,500 unvested Restricted Stock Awards. The Total Non-Derivative Securities Beneficially Owned does not include 144,000 Derivative Securities currently held by Reporting Person.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ------------ ------------ Commitments and contingencies (Note 13) Stockholders' Equity: Preferred stock Series A, $0.001 par value; 250,000 shares authorized; no shares issued or outstanding .... -- -- Common stock, $0.001 par value, 100,000,000 shares authorized; 20,291,433 shares issued and outstanding at December 31, 2007; 18,466,433 at December 31, 2006 .... 20,291 18,466 Additional paid-in capital .... 54,510,161 51,792,502 Accumulated deficit .... (55,292,246) (50,124,739) Accumulated other comprehensive income- foreign currency .... 44,444 -- ------------ ------------ Total stockholders' equity (deficit) .... (717,350) 1,686,229 ------------ ------------ Total liabilities and stockholders' equity ..... $ 22,093,907 $

25,693,428 ============ ============ See accompanying notes. 37 TALON INTERNATIONAL, INC. CONSOLIDATED STATEMENTS OF OPERATIONS Year Ended Year Ended Year Ended December 31, December 31, December 31, 2007 2006 2005 ------------ ------------ ------------ Net sales .... $ 40,529,555 $ 48,825,002 $ 47,331,176 Cost of goods sold .... 28,422,820 34,356,034 47,070,381 ------------ ------------ ------------ Gross profit .... 12,106,735 14,468,968 260,795 Selling expenses .... 3,125,634 2,777,772 2,928,659 General and administrative expenses .... 10,877,374 10,872,887 16,098,363 Bad debt expense (recoveries) .... 186,753 (513,347) 5,857,946 Reserve for impairment of note receivable .... 1,087,653 -- -- Restructuring charges .... -- -- 2,474,281 ------------ ------------ ------------ Total operating expenses .... 15,277,414 13,137,312 27,359,249 Income(loss) from operations .... (3,170,679) 1,331,656 (27,098,454) Interest expense, net .... 1,680,079 988,453 1,379,786 ------------ ------------ ------------ Income(loss) before income taxes .... (4,850,758) 343,203 (28,478,240) Provision for income taxes .... 70,949 33,900 1,059,479 ------------ ------------ ------------ Net income (loss) .... $ (4,921,707) $ 309,303 $(29,537,719) ============ ============ ============ Basic income(loss) per share .... $ (0.24) $ 0.02 $ (1.62) ============ ============ ============ Diluted income(loss) per share .... $ (0.24) $ 0.02 $ (1.62) ============ ============ ============ Basic weighted average shares outstanding . 20,155,563 18,377,484 18,225,851 ============ ============ ============ Diluted weighted average shares outstanding 20,155,563 18,955,796 18,225,851 ============ ============ ============ See accompanying notes. 38 TALON INTERNATIONAL, INC. CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND CONVERTIBLE REDEEMABLE PREFERRED STOCK YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005 Preferred Stock Common Stock Series A -------------------------- --------------------------- Shares Amount Shares Amount ------------ ------------ ------------ ------------ BALANCE, JANUARY 1, 2005 ... 18,171,301 $ 18,173 -- $ -- Common stock issued upon exercise of options and warrants .... 69,744 68 -- -- Net loss .... -- -- -- ------------ ------------ ------------ ------------ BALANCE, DECEMBER 31, 2005 . 18,241,045 18,241 -- -- Common stock issued for services .... 225,388 225 -- -- Stock based compensation ... 362,120 -- Net loss .... -- -- -- -- ------------ ------------ ------------ ------------ BALANCE, DECEMBER 31, 2006 . 18,466,433 18,466 -- -- Common stock issued upon exercise of options ... 75,000 75 -- -- Common stock warrants issued in private placement transaction . 1,750,000 1,750 -- -- Stock based compensation -- -- -- -- Other comprehensive income-foreign currency translation .... -- -- -- -- Adoption of Fin 48 .... -- -- -- -- Net loss .... -- -- -- -- BALANCE, DECEMBER 31, 2007 . 20,291,433 $ 20,291 -- $ -- ============ ============ ============ ============ Additional Other Retained Paid-In Comprehensive Earnings Capital Income (Deficit) Total ------------ ------------ ------------ ------------ BALANCE, JANUARY 1, 2005 ... $ 51,073,402 $ -- (20,896,333) $ 30,195,242 Common stock issued upon exercise of options and warrants .... 254,476 -- -- 254,544 Net loss .... -- -- (29,537,709) (29,537,70) ------------ ------------ ------------ ------------ BALANCE, DECEMBER 31, 2005 . 51,327,878 -- (50,434,042) 912,077 Common stock issued for services .... 102,504 -- -- 102,729 Stock based compensation ... -- 362,120 Net loss .... -- -- 309,303 309,303 ------------ ------------ ------------ ------------ BALANCE, DECEMBER 31, 2006 . 51,792,502 -- (50,124,739) 1,686,229 Common stock issued upon exercise of options ... 42,671 -- -- 42,746 Common stock warrants issued in private placement transaction . 2,429,988 -- -- 2,431,738 Stock based compensation 245,000 -- -- 245,000 Other comprehensive income-foreign currency translation .... -- 44,444 -- 44,444 Adoption of Fin 48 .... -- -- (245,800) (245,800) Net loss .... -- -- (4,921,707) (4,921,707) BALANCE, DECEMBER 31, 2007 . $ 54,510,161 $ 44,444 $(55,292,246) $ (717,350) ============ ============ ============ ============ See accompanying note 39 TALON INTERNATIONAL, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS Year Ended Year Ended Year Ended December 31, December 31, December 31, 2007 2006 2005 ------------ ------------ ------------ CASH FLOWS FROM OPERATING ACTIVITIES: Net income (loss) .... $ (4,921,707) $ 309,303 $(29,537,709) Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: Depreciation and amortization .... 1,168,434 1,523,225 1,931,990 Amortization of deferred financing cost and debt discounts 736,042 -- -- Decrease in deferred income taxes .... -- -- 1,000,000 Common stock and warrants issued for services .... -- 32,729 -- Stock based compensation .... 245,000 362,120 Increase(decrease) in allowance for doubtful accounts .... (935,501) (1,117,500) 2,630,759 Increase(decrease) in inventory valuation reserve .... (68,988) (6,064,000) 940,973 Asset impairment .... 126,904 -- -- Asset impairment due to restructuring .... -- --

2,343,531 Impairment of goodwill .... -- -- 450,000 Disposal of assets .... 58,076 129,179 -- Changes in operating assets and liabilities: Accounts receivable .... 3,258,569 2,086,076 10,666,295 Note receivable collections .... 596,491 640,539 -- Inventories .... 632,781 8,585,879 2,791,747 Prepaid expenses and other current assets .... (404,532) 77,543 1,880,443 Other assets .... (118,499) (140,217) 314,998 Accounts payable .... 2,070,784 (2,587,985) 2,986,302 Accrued legal costs .... 70,929 (442,194) 2,113,197 Other accrued expenses .... (377,565) (733,767) 671,348 Repayment of notes payable converted from accounts payable -- (867,297) -- Income taxes payable .... -- (480) (71,589) ------------ ------------ ------------ Net cash provided by (used in) operating activities .... 2,137,218 1,793,153 1,112,285 ------------ ------------ ------------ CASH FLOWS FROM INVESTING ACTIVITIES: Proceeds from sale of equipment .... -- 2,500 -- Acquisition of property and equipment .... (725,498) (347,188) (1,453,848) ------------ ------------ ------------ Net cash used in investing activities .... (725,498) (344,688) (1,453,848) ------------ ------------ ------------ CASH FLOWS FROM FINANCING ACTIVITIES: Proceeds from secured convertible promissory notes .... -- 254,544 Proceeds from exercise of stock options and warrants .... -- -- (614,506) Payment of capital lease obligations .... (452,232) (604,351) (906,765) Payments on notes payable .... -- (186,838) (1,574,975) Repayment of notes payable .... (1,187,882) -- -- Repayment of related party note payable .... (579,794) -- -- Proceeds from revolver credit facility .... 4,307,806 -- -- Proceeds from stock options and warrants .... 42,746 -- -- Proceeds from term note .... 7,041,852 -- -- Proceeds from note .... 166,753 -- -- Proceeds from related party note .... 125,000 -- -- Payment of financing term note .... (449,840) -- -- Proceeds for equity financing, net of offering costs .... 2,463,017 -- -- Proceeds from cost-equity financing .... 89,868 -- -- Repayment of revolver .... (500,000) -- -- Repayment of convertible note .... (12,500,000) -- -- ------------ ------------ ------------ Net cash (used in) provided by financing activities .... (1,432,706) (791,189) (2,841,702) ------------ ------------ ------------ Net increase (decrease) in cash and cash equivalents .... (20,986) 657,276 (3,183,265) Net effect of foreign currency exchange translation on cash ... 5,171 -- -- ------------ ------------ ------------ Cash and cash equivalents, beginning of year .... 2,934,673 2,277,397 5,460,662 ------------ ------------ ------------ Cash and cash equivalents, end of year .... $ 2,918,858 $ 2,934,673 $ 2,277,397 ============ ============ ============ See accompanying notes. 40 TALON INTERNATIONAL, INC. Year Ended Year Ended Year Ended Consolidated Statements of Cash Flows December 31, December 31, December 31, 2007 2006 2005 ------------ ------------ ------------ SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: Cash received (paid) during the year for: Interest paid .... $ (1,166,333) $ (975,609) $ (1,264,539) Interest received .... $ 182,263 $ 320,232 $ 42,516 Income taxes paid .... $ (90,530) $ (33,900) $ (64,064) Income taxes received .... $ -- $ -- $ 39,571 Non-cash financing activity: Capital lease obligation .... $ 57,793 $ 64,432 $ 273,376 Deferred financing cost .... $ 217,302 $ -- $ -- Effect of foreign currency translation on net assets ...... $ 10,728 $ -- $ -- Accounts receivable, net converted to notes receivable .... $ -- $ -- $ 3,440,000 Trade payable & accrued legal, converted to notes payable.. $ -- $ 1,775,000 $ -- See accompanying notes. 41 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES NATURE OF BUSINESS Talon International, Inc. (the "Company") is an apparel company that specializes in the distribution of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. The Company acts as a full service outsourced trim management department for manufacturers, a specified supplier of trim items to owners of specific brands, brand licensees and retailers, a manufacturer and distributor of zippers under the TALON brand name and a distributor of stretch waistbands that utilize licensed patented technology under the TEKFIT brand name. ORGANIZATION AND BASIS OF PRESENTATION Talon International, Inc. is the parent holding company of Tag-It, Inc., a California corporation, Tag-It Pacific (HK) Ltd., a BVI corporation, Tag-It de Mexico, S.A. de C.V., A.G.S. Stationery, Inc., a California corporation (collectively, the "Subsidiaries"), all of which were consolidated under a parent limited liability company on October 17, 1997 and became wholly-owned subsidiaries of the Company immediately prior to the effective date of the Company's initial public offering in January 1998. Immediately prior to the initial public offering, the outstanding membership units of Tag-It Pacific LLC were converted to 2,470,001 shares of common stock of the Company. In January 2000, the Company formed Tag-It Pacific Limited, a Hong Kong corporation, and in April 2000, the Company formed Talon International, Inc., a Delaware corporation. During 2006 we formed two wholly owned subsidiaries of Tag-It Pacific, Inc.; Talon Zipper (Shenzhen) Company Ltd. in China, and Talon International Pvt. Ltd., in India. All newly formed corporations are 100% wholly-owned Subsidiaries of Talon International, Inc. Logistica en Avios, S.A. de C.V. was an affiliated entity over which the Company exercised control, and as such, is accounted for in the same manner as a wholly-owned subsidiary. On July 20, 2007, the Company changed its corporate name from Tag-It Pacific, Inc. to Talon International, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation. Assets and liabilities of foreign subsidiaries are translated at rates of exchange in effect at the close of the period. Revenues and expenses are translated at the weighted average of exchange rates in effect during the year. The resulting translation gains and losses are deferred and are shown as a separate component of stockholders' equity, if material, and transaction gains and losses, if any, are recorded in the consolidated statement of income in the period incurred. During 2007, 2006 and 2005, foreign currency translation and transaction gains and losses were not material. The Company does not engage in hedging activities with respect to exchange rate risk. USE OF ESTIMATES The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. 42 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CASH AND CASH EQUIVALENTS The Company considers all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents. The Company had approximately $2.7 million and $2.9 million at financial institutions in excess of federally insured limits at December 31, 2007 and 2006. MARKETABLE SECURITIES The portfolio of marketable securities is stated at the lower of cost or market at the balance sheet date and consists of common stocks. The Company accounts for its investments, which are all available for sales securities, under the provisions of Statement of Financial Accounting Standards ("SFAS") 115, "Accounting for Certain Investments in Debt and Securities". Realized gains or losses are determined on the specific identification method and are reflected in income. Unrealized losses are recorded directly in other comprehensive income except those unrealized losses that are deemed to be other than temporary, which losses are reflected in income. See Note 2 of the Consolidated Financial Statements. ALLOWANCE FOR DOUBTFUL ACCOUNTS We are required to make judgments as to the collectibility of accounts receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts receivable that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables to their net realizable value. We record 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. See Note 3 of the Consolidated Financial Statements. INVENTORIES Inventories are stated at the lower of cost, determined using the first-in, first-out basis, or market value and are all substantially finished goods. The costs of inventory include the purchase price, inbound freight and duties, conversion costs and certain allocated production overhead costs. Inventory reserves are recorded for damaged, obsolete, excess and slow-moving inventory. 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. Inventories consist of the following: Year Ended December 31, ------------------------------ 2007 2006 ---------- ---------- Finished goods .... $3,506,439 $4,293,220 Less reserves .... 1,019,012 1,242,000 ---------- ---------- Total inventories .... $2,487,427 $3,051,220 ========== ========== 43 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS PROPERTY AND EQUIPMENT AND FIXED ASSETS HELD FOR SALE Property and equipment are recorded at historical cost. Maintenance and repairs are expensed as incurred. Upon retirement or other disposition of property and equipment, the related cost and accumulated depreciation or amortization are removed from the accounts and any gains or losses are included in results of operations. Depreciation of property and equipment is computed using the straight-line method based on estimated useful lives as follows:

Furniture and fixtures 5 years Machinery and equipment 5 to 10 years Computer equipment 5 years Leasehold improvements Term of the lease or the estimated life of the related improvements, whichever is shorter. Dies, and molds 3 months to 1 years Idle equipment 5 to 10 years Property and equipment consist of the following: Year Ended December 31, -------------------------- 2007 2006 ----------- ----------- Furniture and fixtures .... $ 600,491 $ 582,832 Machinery and equipment .... 1,694,921 1,682,296 Computer equipment .... 4,137,834 3,422,058 Leasehold improvements .... 248,129 214,807 Dies, and molds .... 106,273 106,273 Idle equipment .... 4,198,880 4,434,980 ----------- ----------- 10,986,528 10,443,246 Accumulated depreciation and amortization ...... 5,776,082 4,820,206 ----------- ----------- Net property and equipment .... $ 5,210,446 $ 5,623,040 =========== =========== Depreciation expense for the years ended December 31, 2007, 2006 and 2005 was $1,136,000, $1,090,000, and $1,499,000, respectively. During the year ended December 31, 2007, the Company wrote-off fixed assets with a net book of value of $54,000 related to scrap dies and molds. During the year ended December 31, 2005, the Company wrote-off fixed assets with a net book value of $2,036,000 in connection with the 2005 restructuring plan. Idle equipment is principally machinery and equipment used for the production of zipper chain and the assembly of finished zippers. This equipment was originally associated with the production and assembly facilities in North Carolina and in Mexico, and was temporarily rendered idle with the closing of these operations in connection with the 2005 Restructuring Plan. The Company intends to redeploy this equipment during the next year within production operations being established in Asia and India. The equipment continues to be depreciated based upon its estimated useful lives. 44 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The Company has evaluated the idle equipment for impairment and has determined that an impairment does not exist at December 31, 2007. If future events occur that adversely affect the idle equipment the Company will record an impairment. Fixed assets held for sale consists of the North Carolina land and manufacturing facility. Management has the authority and has committed to sell the asset; the asset is listed for sale with a commercial real estate agent who is actively marketing the property; the sale of the asset is probable and the sale is expected to be completed within one year. See Note 11, "2005 Restructuring Plan". This asset held for sale is financed by a mortgage note with a balance of $690,000 at December 31, 2007 and $713,000 at December 31, 2006. OTHER INTANGIBLE ASSETS Intangible assets consist of tradename and exclusive license and intellectual property rights. Intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB Statement No. 142, Goodwill and Other Intangible Assets. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives, which average 5 years, to their estimated residual values, and reviewed for impairment in accordance with FASB Statement No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. At December 31, 2007, the Company evaluated its Other Intangible Assets and determined that there was no impairment of these assets and made no changes to the net carrying amount of Tradename for the years ended December 31, 2007 and 2006. Amortization expense related to exclusive license and intellectual property rights of $115,500 were recorded for each of the years ended December 31, 2006 and 2005. During the first quarter of 2007, the exclusive license and intellectual property became fully amortized. For the year ended December 31, 2007, amortization expense of $29,000 was recorded. Other intangible assets as of December 31, 2007 and 2006 are as follows: Year Ended December 31, --------------------------- 2007 2006 ----------- ----------- Other Intangible Assets: Tradename .... $ 4,110,750 $ 4,110,750 Accumulated amortization .... -- -- ----------- ----------- Tradename, net .... 4,110,750 4,110,750 Exclusive license and intellectual property rights .... 577,500 577,500 Accumulated amortization .... (577,500) (548,625) ----------- ----------- Exclusive license and intellectual property rights, net .... 0 28,875 ----------- ----------- Other intangible assets, net .... $ 4,110,750 $ 4,139,625 =========== =========== IMPAIRMENT OF LONG-LIVED ASSETS 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 have historically caused us to reassess the carrying amount of our long-lived assets. 45 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS During the year ended December 31, 2007, the Company recorded an impairment on the building held for sale of $127,000 reducing the carrying value of the building to $700,000. No impairment was recorded in 2006. During the year ended December 31, 2005, the Company recorded asset impairment charges in connection with its 2005 Restructuring Plan (See Note 11). INCOME TAXES Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax benefit carry-forwards. Deferred tax liabilities and assets at the end of each period are determined using enacted tax rates. The Company records deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if 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. The provisions of SFAS No. 109, "Accounting for Income Taxes," require the establishment of a valuation allowance when, based on currently available information and other factors, it is more likely than not that all or a portion of a deferred tax asset will not be realized. SFAS No. 109 provides that an important factor in determining whether a deferred tax asset will be realized is whether there has been sufficient income in recent years and whether sufficient income is expected in future years in order to utilize the deferred tax asset. The Company believes that its estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. On January 1, 2007 the Company adopted the provisions of Financial Accounting Standard Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on the recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition associated with income tax liabilities. As a result of the implementation of FIN 48, the Company recognized an increase in liabilities for unrecognized tax benefits of approximately $246,000, which was accounted for as an increase in the January 1, 2007 accumulated deficit. 46 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS STOCK-BASED COMPENSATION On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") 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. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company's financial statements as of and for the years ended December 31, 2006 and 2007 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). There was no stock-based compensation expense related to employee or director stock options recognized during the year ended December 31, 2005. Options issued to consultants are accounted for in accordance with the provisions of Emerging Issues Task Force (EITF) No. 96-18, "Accounting for Equity Instruments That Are Issued to Others Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." As a result of adopting SFAS 123(R) on January 1, 2006, the Company's income before income taxes and net income for the year ended December 31, 2007 and 2006 are $245,000 and $395,000, respectively, lower than if it had continued to account for share-based compensation under APB Opinion 25. The following table illustrates the effect on net income and loss per share if the Company had applied the fair value recognition provisions of SFAS 123(R) to stock-based awards granted under the Company's stock option plans in all periods presented. For purposes of this pro-forma disclosure, the fair value of the options is estimated using the Black-Scholes-Merton option-pricing formula ("Black-Scholes model") and amortized to expense generally over the options' vesting periods. 2005 ------------ Net loss as reported .... $(29,537,709) Add: Stock-based employee compensation expense included in reported net income, net of related tax effects .... -- Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects .... (221,167) ------------ Pro forma net loss .... $(29,758,876) ============ Loss per share: Basic - as reported .... $ (1.62) Basic - pro forma .... $ (1.63) 47 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SFAS 123(R) requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statements of Operations. Stock-based compensation expense recognized in the Statements of Operations for the years ended December 31, 2006 and 2007 included compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1 of the applicable year based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS 123(R) and compensation expense for the share-based payment awards granted subsequent to January 1 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with how the prior-period pro formas were provided. As stock-based compensation expense recognized in the Statements of Operations for 2006 and 2007 is based on awards expected to vest, SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the years ended December 31, 2006 and 2007, expected forfeitures are immaterial and as such the Company is recognizing forfeitures as they occur. In the pro-forma information provided under SFAS 123(R) for the periods prior to 2006, the Company accounted for forfeitures as they occurred. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB Opinion 25. Under the intrinsic value method, the Company recognized share-based compensation equal to the award's intrinsic value at the time of grant over the requisite service periods using the straight-line method. Forfeitures were recognized as incurred. During the year ended December, 31, 2005, there was no stock-based compensation expense recognized in the Statements of Operations for awards issued to employees and directors as the awards had no intrinsic value at the time of grant because their exercise prices equaled the fair values of the common stock at the time of grant. The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards, and actual and projected employee stock option exercise behaviors. The Company estimates expected volatility using historical data. The expected option term is estimated using the "safe harbor" provisions under SAB 107. The Company has elected to adopt the detailed method provided in SFAS 123(R) for calculating the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). FOREIGN CURRENCY TRANSLATION The Company has operations and holds assets in various foreign countries. The local currency is the functional currency for our subsidiaries in China and India. Assets and liabilities are translated at end-of-period exchange rates while revenues and expenses are translated at the average exchange rates in effect during the period. Equity is translated at historical rates and the resulting cumulative translation adjustments are included as a component of accumulated other comprehensive income (loss) until the translation adjustments are realized. 48 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS COMPREHENSIVE INCOME The Company has adopted Statement of Financial Standard No. 130, "Reporting Comprehensive Income" ("SFAS 130"), issued by the FASB and effective for financial statements with fiscal years beginning after December 15, 1997. SFAS 130 establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. Included in comprehensive income for the year ended December 31, 2007 are unrealized gains in foreign currency translation gain of $44,000. The foreign currency translation adjustment represents the net currency translation adjustment gains and losses related to our China and India subsidiaries, There were no material other comprehensive income items for the years ended December 31, 2007 and 2006. REVENUE RECOGNITION Sales are recognized when persuasive evidence of an arrangement exists, product delivery has occurred, pricing is fixed or determinable, and collection is reasonably assured. Sales resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns, and the cost of products sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances. Sales rebates and discounts are common practice in the industries in which the Company operates. Volume, promotional, price, cash and other discounts and customer incentives are accounted for as a reduction to gross sales. Rebates and discounts are recorded based upon estimates at the time products are sold. These estimates are based upon historical experience for similar programs and products. The Company reviews such rebates and discounts on an ongoing basis and accruals for rebates and discounts are adjusted, if necessary, as additional information becomes available. RECLASSIFICATION Certain reclassifications have been made to the prior year financial statements to conform to 2007 presentation. CLASSIFICATION OF EXPENSES COST OF SALES - Cost of goods sold primarily includes expenses related to inventory purchases, customs, duty, freight, overhead expenses and reserves for obsolete inventory. Overhead expenses primarily consist of warehouse and operations salaries, and other warehouse expenses. SELLING EXPENSE - Selling expenses primarily include royalty expense, sales salaries and commissions, travel and entertainment, marketing and other sales-related costs. GENERAL AND ADMINISTRATIVE EXPENSES - General and administrative expenses primarily include administrative salaries, employee benefits, professional service fees, facility expenses, information technology costs, investor relations, travel and entertainment, depreciation and amortization, bad debts, restructuring costs and other general corporate expenses. 49 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS INTEREST EXPENSE AND INTEREST INCOME - Interest expense reflects the cost of borrowing and amortization of deferred financing costs and discounts. Interest expense for the years ended December 31, 2007, 2006 and 2005 was $1,922,000, $1,357,000 and $1,446,000, respectively. Interest income of $242,000, $368,000 and $66,000 for the years ended December 31, 2007, 2006 and 2005, respectively, consists of earnings from outstanding amounts due to the Company under notes and other interest bearing receivables. SHIPPING AND HANDLING COSTS In accordance with Emerging Issues Task Force 00-10, Accounting for Shipping and Handling Fees and Costs, the Company records shipping and handling costs billed to customers as a component of revenue, and shipping and handling costs incurred by the Company for outbound freight are recorded as a component of cost of sales. Total shipping and handling costs included as a component of revenue for the years ended December 31, 2007, 2006 and 2005 amounted to $235,000, $146,000, and $98,000, respectively. Total shipping and handling costs included as a component of cost of sales for each of these years amounted to $1,105,000, $691,000, and $925,000. RESTRUCTURING CHARGES The Company records restructuring reserves in compliance with SFAS 146 "Accounting for Costs Associated with Exit or Disposal Activities", resulting in the recognition of employee severance and related termination benefits for recurring arrangements as they are incurred and on the accrual basis for one-time benefit arrangements. The Company records other costs associated with exit activities as they are incurred. Employee severance and termination benefits are estimates based on agreements with the relevant union representatives or plans adopted by the Company that are applicable to employees not affiliated with unions. These costs are not associated with nor do they benefit continuing activities. Inherent in the estimation of these costs are assessments related to the most likely expected outcome of the significant actions to accomplish the restructuring. Changing business conditions may affect the assumptions related to the timing and extent of facility closure activities. The Company reviews the status of restructuring activities on a quarterly basis and, if appropriate, records changes based on updated estimates. See Note 11, "2005 Restructuring Plan". LITIGATION 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 SFAS No. 5, "Accounting for 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. FAIR VALUE OF FINANCIAL INFORMATION The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value. ACCOUNTS RECEIVABLE: Due to the short-term nature of the receivables, the fair value approximates the carrying value. DUE FROM RELATED PARTIES AND NOTES PAYABLE TO RELATED PARTIES: Due to the short-term nature and current market borrowing rates of the loans and notes, the fair value approximates the carrying value. NOTES PAYABLE: Fair value approximates carrying value based upon current market borrowing rates for loans with similar terms and maturities.

50 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NEW ACCOUNTING PRONOUNCEMENTS In September 2006, the FASB issued SFAS No. 157, FAIR VALUE MEASUREMENTS ("SFAS 157"), which defines fair value, provides a framework for measuring fair value and expands the disclosures required for fair value measurements. SFAS 157 applies to all accounting pronouncements that require fair value measurements; it does not require any new fair value measurements. For fiscal years beginning after November 15, 2007, companies will be required to implement SFAS 157 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. The FASB did, however, provide a one-year deferral for the implementation of Statement 157 for other nonfinancial assets and liabilities. An exposure draft will be issued for comment in the near future on this partial deferral. Accordingly, we will adopt SFAS 157 for financial assets and liabilities commencing in the first quarter of 2008. We are currently assessing the potential impact of SFAS 157 on our consolidated financial statements. In February 2007, the FASB issued SFAS No. 159, THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND LIABILITIES - INCLUDING AN AMENDMENT OF FASB STATEMENT NO. 115 ("SFAS 159") . SFAS 159 permits entities to choose to measure certain financial assets and liabilities at fair value. Unrealized gains and losses, arising subsequent to adoption are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and, accordingly, we will adopt SFAS 159 in the first quarter of 2008. We are currently assessing the impact of SFAS 159 on our consolidated financial statements. In December 2007, the SEC issued SAB No. 110, CERTAIN ASSUMPTIONS USED IN VALUATION METHODS - EXPECTED TERM ("SAB 110"). According to SAB 110, under certain circumstances the SEC staff will continue to accept beyond December 31, 2007 the use of the simplified method in developing an estimate of expected term of share options that possess certain characteristics in accordance with SFAS 123(R) beyond December 31, 2007. We will adopt SAB 110 effective January 1, 2008 and continue to use the simplified method in developing the expected term used for our valuation of stock-based compensation. In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations ("SFAS 141(R)"). SFAS 141(R) establishes principles and requirements for how the acquiror of a business (a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; (b) recognizes and measures in its financial statements the goodwill acquired in the business combination or a gain from a bargain purchase; and (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning on or after December 15, 2008 and, accordingly, we will apply SFAS 141(R) for acquisitions effected subsequent to the date of adoption. In December 2007, the FASB issued SFAS No. 160, NONCONTROLLING INTERESTS IN CONSOLIDATED FINANCIAL STATEMENTS--AN AMENDMENT OF ACCOUNTING RESEARCH BULLETIN NO. 51 ("SFAS 160"). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective beginning January 1, 2009. We are currently assessing the potential impact of SFAS 160 on our consolidated financial statements. 51 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 2--MARKETABLE SECURITIES On December 31, 2007, the Company obtained 2,000,000 shares of unrestricted common stock with a value of $1,040,000 in exchange for the Azteca Note Receivable discussed in Note 3. Pursuant to restrictions on the sale of these shares on the open market, the Company is limited to selling no more than 10,000 shares per day unless the Company sells the shares through a private sale. The portfolio of marketable securities is stated at the lower of cost or market at the balance sheet date and consists of common stocks. No realized or unrealized gains or losses were recognized during the year ended December 31, 2007. The value of the common stock on April 10, 2008 had decreased $340,000 to $700,000. NOTE 3--ACCOUNTS AND NOTE RECEIVABLE At December 31, 2006 a note receivable from Azteca Productions International, Inc. ("Azteca") was outstanding in the amount of $2,799,460. The note was a receivable to be paid in monthly installments over thirty-one months beginning March 1, 2006. The payments were $50,000 per month for the first 5 months, and then ranged from $133,000-$267,000 per month until paid in full, but no later than July 1, 2008. Azteca failed to make the scheduled note payments due on July 1, 2007, and all subsequent periods thereafter, triggering a default and exhausting all cure periods under the note, resulting in the entire note balance being due and

payable. On September 10, 2007 after meeting with and conducting extensive discussions with Azteca, Azteca failed to provide to the Company certain security interests as required under the note to make the scheduled note payments and Azteca further expressed its belief that it would be unable to make any note payments in the foreseeable future. As a result, in September 2007, the Company reflected a charge of $2,127,653 to fully reserve the outstanding balance from Azteca. In December 2007, an agreement was reached whereby Azteca delivered shares of common stock in lieu of the note receivable. In December 2007, the Company reversed part of the impairment recorded in September 2007 and reflected income of $1,040,000. Accounts receivable are included on the accompanying consolidated balance sheet net of an allowance for doubtful accounts. The total allowance for doubtful accounts at December 31, 2007 and 2006 was $140,420 and$71,500, respectively. 52 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 4--DEMAND NOTES PAYABLE TO RELATED PARTIES Demand notes payable to related parties consist of the following: Year Ended December 31, ------------------- 2007 2006 -------- -------- Two notes payable issued from 1995-1998 to parties related to or affiliated with directors of the Company with interest rates ranging from 0% to 10% per annum, due and payable on the fifteenth day following delivery of written demand for payment ...... $ 85,176 $ 85,176 Convertible secured note payable issued in October 2000 to a director of the Company bears interest at 11%, payable quarterly, is due on demand and convertible into common stock at the election of the holder at a rate of $4.50 per share, the market value of the Company's common stock on the date of approval by the Company's Board of Directors. The note is secured by substantially all of the Company's assets .... -- 500,000 Unsecured notes payable to a director of the Company accrue interest at 7% and 8.5% per annum, principal and interest due on demand and fifteen days from demand -- 79,795 -------- -------- $ 85,176 $664,971 ======== ======== Interest expense related to the demand notes payable to related parties for the years ended December 31, 2007, 2006 and 2005 amounted to $30,568, $67,753 and $67,753, respectively. Included in accrued expenses at December 31, 2007 and 2006 was $127,915 and $515,738 of related accrued interest. Interest paid on the demand notes during the year ended December 31, 2007 was $518,546. There was no interest paid on the demand notes during the year ended December 31, 2006. NOTE 5--CAPITAL LEASE OBLIGATIONS The Company financed equipment purchases through various capital lease obligations expiring through March 2010. These obligations bear interest at various rates ranging from 4.6% to 12% per annum. Future minimum annual payments under these capital lease obligations are as follows: YEARS ENDING DECEMBER 31, Amount --------- 2008 .... $ 363,200 2009 .... 196,222 2010 .... 2,378 2011 .... -- 2012 and thereafter .... -- --------- Total payments .... 561,800 Less amount representing interest .... (48,778) --------- Balance at December 31, 2007 .... 513,022 Less current portion .... 323,317 --------- Long-term portion .... $ 189,705 ========= 53 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS At December 31, 2007, total property and equipment under capital lease obligations and related accumulated depreciation was $3,533,154 and $1,635,697, respectively. At December 31, 2006, total property and equipment under capital lease obligations and related accumulated depreciation was $3,533,154 and $1,178,469, respectively. NOTE 6--NOTES PAYABLE Notes payable consist of the following: Year Ended December 31, ---------------------- 2007 2006 ---------- ---------- $765,000 note payable to First National Bank dated June 3, 2004; interest at 6.5%; payable in eighty-four monthly payments of principal and interest of $5,746 beginning July 2004; twenty-year amortization, all unpaid principal and interest due June 3, 2011 (seven years); secured by building in North Carolina .... $ 689,651 $ 712,950 $880,000 note payable to First National Bank dated November 22, 2004; interest at 6.5%; payable in sixty monthly payments of principal and interest of $17,254 beginning December 2004; all unpaid principal and interest due November 22, 2009; secured by manufacturing equipment .... 371,863 548,068 $1,650,000 note payable to Hennigan, Bennett & Dorman, LLP dated May 31, 2006; interest at 3.0%; payable in fourteen monthly payments of principal and interest beginning June 2006, of $50,000 for the first two payments, and $133,333 for the next twelve months thereafter until July 1, 2007; secured by the note receivable .... -- 907,703 $180,000 note payable to Next Trim, LLC dated January 22, 2007; interest at 6.5%; payable in twenty-four monthly payments of principal and interest beginning January 2007, of $7,500 until December 2008 .... 86,078 -- ---------- ---------- Notes Payable .... 1,147,592 2,168,721 Less Current portion .... 299,108 1,107,207 ---------- ---------- Notes payable, net of current portion .... $ 848,484 $1,061,514 ========== ========== Future minimum annual payments under these notes payable obligations are as follows: YEARS ENDING

DECEMBER 31, Amount ---------- 2008 .... $ 299,108 2009 .... 210,218 2010 .... 28,301 2011 .... 609,965 2012 and thereafter .... -- ---------- Total .... $1,147,592 ========== 54 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 7--DEBT FACILITY On June 27, 2007 the Company entered into a Revolving Credit and Term 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. The revolving credit portion of the facility permits borrowings based upon a formula including 75% the Company's eligible receivables and 55% of eligible inventory, and provides for monthly interest payments at the prime rate plus 2.0%. The term loan bears interest at 8.5% annually with quarterly interest payments and repayment in full at maturity. Borrowings under both credit facilities are secured by all of the assets of the Company. Under the terms of the credit agreement the Company is required to meet certain cash flow and coverage ratios, among other restrictions including a restriction from declaring or paying a dividend prior to repayment of all the obligations. The financial covenants require the Company to maintain at the end of each fiscal quarter "EBITDA" (as defined in the Agreement) for the preceding four quarters in excess of the Company's principal and interest payments for the same four-quarter period. In the event that the Company fails to satisfy the minimum EBITDA requirement for two consecutive quarters, the credit agreement will be in default and the full amount of the notes outstanding will become due. For the period ended September 30, 2007 the Company believes that this EBITDA covenant was satisfied, but also informed the lender that the Company may fail to satisfy the EBITDA covenant for the quarters ending December 31, 2007 or March 31, 2008. The Company requested the lender to amend the loan agreement to allow for additional time to satisfy the covenant. On November 19, 2007 the Company entered into an agreement with Bluefin Capital, LLC to modify this financial covenant and to extend until June 30, 2008 (with a further extension to March 31, 2009 provided certain conditions are met by June 30 2008) the application of the EBITDA covenant in exchange for additional common stock of the Company and a price adjustment to the lenders outstanding warrants issued in connection with the loan agreement. At closing on June 27, 2007, the proceeds of the term loan in the amount of $9.5 million were deposited into a restricted cash escrow account and $3.0 million of the borrowings available under the revolving credit note were reserved and held for payment of the Company's $12.5 million convertible promissory notes maturing in November 2007. During July 2007 waivers were obtained from all holders of the convertible promissory notes allowing for early payment of their notes without penalty, and as of July 31, 2007 all of the note holders had been paid in full. At closing the Company also borrowed $1,004,306 under the revolving credit note and used the proceeds to pay the related party note payable and accrued interest due to Mark Dyne, Chairman of the Board of the Company. Additionally initial borrowings under the revolving credit note were used to pay the loan and legal fees due at closing. As of September 30, 2007 the Company had borrowed $9.5 million under the term note, and $3,807,806 under the revolving credit note. In connection with the Revolving Credit and Term Loan Agreement, the Company issued 1,500,000 shares of common stock to the lender for $0.001 per share, and issued 2,100,000 warrants for the purchase of common stock. The warrants were exercisable over a five-year period and 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 relative fair value ($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 to be 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. The costs allocable to the debt instruments are reflected in other assets as deferred financing costs and are being amortized over the term of the notes. 55 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS On November 19, 2007, the Company completed an amendment on its debt facility and issued an additional 250,000 shares of common stock to the lender for $0.001 per share. The exercisable price for 2,100,000 warrants issued for the purchase of common stock was amended to an issuable price of $0.75 per share. The new relative fair value ($2,402,936, which includes a reduction for financing costs) of the equity 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 to be amortized over the term of the note and recognized as additional interest cost as amortized. If the Company does not meet a requirement to register the common shares and warrants by May 15, 2008, the Company will incur a penalty of $1,000 per day up to a maximum of $700,000. On April 3, 2008 the Company executed an amendment to the existing revolving credit and term loan agreement with Bluefin Capital. The amendment provided for an amendment of the EBITDA and other financial covenants, and the redemption of the stock warrants previously issued to Bluefin Capital in exchange for the issuance of an additional note payable to Bluefin Capital for $1.0 million at an interest rate of 8.5%. The Company will record a reduction to equity and an increase to notes payable for the fair value of the warrants redeemed. The difference between the fair value of the warrants of $221,723 and the face value of the note will be accreted over the life of the note. The note will incur interest at 8.5% on the principal amount of $1.0 million and the quarterly accretion will also be reflected as interest expense. The additional note and all accrued interest under the note are due and payable on June 30, 2010. Interest expense related to the Revolving Credit and Term Loan Agreement for the year ended December 31, 2007 was $1,008,520, which includes $461,102 in amortization of discounts and deferred financing costs. NOTE 8--STOCKHOLDERS' EQUITY AND CONVERTIBLE REDEEMABLE PREFERRED STOCK PREFERRED STOCK STOCKHOLDER'S RIGHTS PLAN In October 1998, the Company adopted a stockholder's rights plan. Under the rights plan the Company distributed one preferred share purchase right for each outstanding share of Common Stock outstanding on November 6, 1998. Upon the occurrence of certain triggering events related to an unsolicited takeover attempt of the Company, each purchase right not owned by the party or parties making the unsolicited takeover attempt will entitle its holder to purchase shares of the Company's Series A Preferred Stock at a value below the then market value of the Series A Preferred Stock. The rights of holders of the Common Stock will be subject to, and may be adversely affected by, the rights of holders of the share purchase rights, the Series A Preferred Stock and any other preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could make it more difficult for a third party to acquire a majority of the Company's outstanding voting stock. COMMON STOCK 2003 PRIVATE PLACEMENT On May 30, 2003, the Company raised approximately $6,037,500 in a private placement transaction with five institutional investors. Pursuant to a securities purchase agreement with these institutional investors, the Company sold 1,725,000 shares of its common stock at a price per share of $3.50. After commissions and expenses, the Company received net proceeds of approximately 56 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $5.5 million. The Company has registered the shares issued in the private placement with the Securities and Exchange Commission for resale by the investors. In conjunction with the private placement transaction, the Company issued warrants to purchase 172,500 shares of common stock to the placement agent. The warrants are exercisable beginning August 30, 2003 through May 30, 2008 and have a per share exercise price of $5.06. EXCLUSIVE LICENSE AND INTELLECTUAL PROPERTY RIGHTS AGREEMENT On April 2, 2002, the Company entered into an Exclusive License and Intellectual Property Rights Agreement (the "Agreement") with Pro-Fit Holdings Limited ("Pro-Fit"). The Agreement gives the Company the exclusive rights to sell or sublicense waistbands manufactured under patented technology developed by Pro-Fit for garments manufactured anywhere in the world for the United States market and all United States brands. In accordance with the Agreement, the Company issued 150,000 shares of its common stock which were recorded at the market value of the stock on the date of the Agreement. The shares contain restrictions related to the transfer of the shares and registration rights. The Agreement has an indefinite term that extends for the duration of the trade secrets licensed under the Agreement. The Company has recorded an intangible asset amounting to $577,500, which was fully amortized by the year ended December 31, 2007. The Company is currently in litigation with this supplier (See Notes 1 and 13). NOTE 9--STOCK OPTION INCENTIVE PLAN AND WARRANTS STOCK OPTION INCENTIVE 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. At December 31, 2007 no awards under the 2007 Stock Plan had been granted. On October 1, 1997, the Company adopted the 1997 Stock Incentive Plan (the "1997 Plan"), which authorized the granting of a variety of stock-based incentive awards. The Board of Directors, who determines the recipients and terms of the awards granted, administers the 1997 Plan. On July 31, 2006 at the Company's annual meeting of stockholder's two amendments to the 1997 Stock Plan were approved which (1) increased the maximum number of shares of common stock that may be issued pursuant to awards granted under the 1997 Plan from 3,077,500 shares to 6,000,000 shares, and (2) increased the number of shares of common stock that may be issued pursuant to awards granted to any individual under the plan in a single year to 50% of the total number of shares available under the plan. The Company believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Company's stock on the date of the grant for years prior to 2006, and for the years ending after 2006, the average market price of the Company's stock for the five trading days prior to the date of the grant; those option awards generally vest over periods determined by the Board from immediate to 4 years of continuous service, and have 10 year contractual terms. The following table summarizes all options issued to employees and directors including those issued outside the plan. 57 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The following table summarizes the activity for the periods: Weighted Average Number of Exercise EMPLOYEE AND DIRECTOR Shares Price ---------- ---------- Options outstanding - January 1, 2005 .... 1,742,000 $ 3.53 Granted .... 425,000 $ 3.22 Exercised .... (1,250) $ 3.63 Canceled .... (332,750) $ 3.50 ---------- ---------- Options outstanding - December 31, 2005 ..... 1,833,000 $ 3.46 Granted .... 3,471,135 $ 0.31 Canceled .... (301,500) $ 3.56 ---------- ---------- Options outstanding - December 31, 2006 ..... 5,002,635 $ 1.41 Granted .... 46,600 $ 1.02 Exercised .... (75,000) $ 0.57 Canceled .... (376,000) $ 0.76 ---------- ---------- Options outstanding - December 31, 2007 ..... 4,598,235 $ 1.46 ========== ========== The Company has also issued certain warrants and options to non-employees. As of December 31, 2007, there were warrants issued to acquire a total of 3,163,813 shares of common stock, outstanding to non-employees. During 2007 the Company issued 1,750,000 shares of stock to its lender with a fair market value of $1,637,500. The following table summarizes the activity for the periods: Weighted Average Number of Exercise NON-EMPLOYEES Shares Price ---------- ---------- Options & warrants outstanding - January 1, 2005 .. 1,578,973 $ 4.35 Granted .... -- $ -- Exercised .... (68,494) $ 3.65 Canceled .... (133,332) $ 4.54 ---------- ---------- Options & warrants outstanding - December 31, 2005 1,377,147 $ 4.36 Granted .... 75,000 $ 0.57 Exercised .... -- $ -- Canceled .... (133,334) $ 4.54 ---------- ---------- Options & warrants outstanding - December 31, 2006 1,318,813 $ 4.13 Granted .... 2,100,000 $ 0.75 Canceled .... (180,000) $ 3.63 ---------- ---------- Options & warrants outstanding - December 31, 2007 3,238,813 $ 2.00 ========== ========== The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model and the assumptions noted in the following table for the years ended December 31, as indicated. Expected volatilities are based on the historical volatility of the Company's stock price and other factors. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards, and actual and projected employee stock option exercise behaviors. The expected option term is estimated using the "safe harbor" provisions under SAB 58 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS 107. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield in effect at the time of the grant. 2007 2006 2005 ------- ------- ------- Expected volatility .... 64% 65% 64% Expected term in years .... 6.1 yrs 6.1 yrs 1.2 yrs Expected dividends .... -- -- -- Risk-free rate .... 4.8% 4.5% 2.0% A summary of the option activity under the 1997 Plan as of December 31, 2007, and changes during the year then ended is as follows: Weighted Weighted Average Average Remaining Number of Exercise Contractual Intrinsic EMPLOYEE AND DIRECTOR Shares Price Life (Years) Value ------------ ------------ ------------ ------------ Outstanding at December 31, 2007 ... 7,837,048 $ 1.74 5.44 $ 75,405 Vested and Expected to Vest .... 7,783,316 $ 1.75 5.42 $ 74,176 Exercisable .... 6,608,782 $ 1.95 4.91 $ 53,128 The weighted average grant-date fair value of options granted to employees and directors during the years ended December 31, 2007 and 2006 were $0.33 and $0.31, respectively. The total intrinsic value of options exercised during the year ended December 31, 2005 was $1,700. There were no options exercised in 2007 and 2006. Weighted Weighted Average Average Remaining Number of Exercise Contractual Intrinsic NON-EMPLOYEE OPTIONS & WARRANTS Shares Price Life (Years) Value ------------ ------------ ------------ ------------ Outstanding at December 31, 2007 ... 3,163,813 $ 1.99 4.5 $ 31,638 Vested and Expected to Vest .... 3,163,813 $ 1.99 4.5 $ 31,638 Exercisable .... 3,163,813 $ 1.99 4.5 $ 31,638 59 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The weighted average grant-date fair value of options and warrants granted to non-employees during the years ended December 31, 2007 and 2006 was $0.75 and $0.57, respectively. There were no grants in 2005. The total intrinsic value of options and warrants exercised during the years ended December 31, 2007 and 2005 was $21,000 and $91,000, respectively. There were no options exercised in 2006. The fair value of the awards approximates the values expensed for pro-forma purposes for these periods. As of December 31, 2007, there was $398,000 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted, including warrants. This cost is expected to be recognized over the weighted-average period of 2.0 years. The total fair value of shares vested during the years ended December 31, 2007, 2006 and 2005 was $245,000, $236,000, and $217,000, respectively. When options are exercised, the Company's policy is to issue previously registered, unissued shares of common stock. As of December 31, 2006, the Company had 2,321,977 unissued shares of common stock available in its 1997 Plan. On July 31, 2007, at the Company's annual meeting of stockholders, the 2007 Stock Plan was approved, which authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. The 2007 Plan shares have not yet been registered. NOTE 10--INCOME (LOSS) PER SHARE The following is a reconciliation of the numerators and denominators of the basic and diluted income (loss) per share computations: December 31, 2007 December 31, 2006 -- -- Years ended: Loss Shares Per Share Income Shares Per Share (Numerator) (Denominator) Amount (Numerator) (Denominator) Amount ------------ ------------ ------------ ------------ ------------ ------------ Basic income (loss): Income (loss) available to common stockholders ... $ (4,921,707) 20,155,563 $ (0.24) $ 309,303 18,377,484 $ 0.02 Effect of dilutive securities: Options .... -- -- -- -- 578,312 $ 0.00 Warrants .... -- -- -- -- -- -- ------------ ------------ ------------ ------------ ------------ ------------ Income (loss) available to common stockholders .... $ (4,921,707) 20,155,563 $ (0.24) $ 309,303 18,955,796 $ 0.02 ============ ============ ============ ============ ============ ============ December 31, 2005 -- Years ended: Loss Shares Per Share (Numerator) (Denominator) Amount ------------ ------------ ------------ Basic income (loss): Income (loss) available to common stockholders ... $(29,537,709) 18,225,851 $ (1.62) Effect of dilutive securities: Options .... -- -- -- Warrants .... -- -- -- ------------ ------------ ------------ Income (loss) available to common stockholders .... $(29,537,709) 18,225,851 $ (1.62) ============ ============ ============ Warrants to purchase 3,163,813 shares of common stock at between $0.75 and $5.06 and options to purchase 4,653,235 shares of common stock at between $0.37 and $5.23, per share were outstanding for the year ended December 31, 2007, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share. Warrants to purchase 1,243,813 shares of common stock at between $3.50 and $5.06; options to purchase 1,642,500 shares of common stock at between $1.27 and $5.23; convertible debt of $12,500,000 convertible at $3.65 per share, and other convertible debt of $500,000 convertible at $4.50 per share were outstanding for the year ended December 31, 2006, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on the income per share. 60 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Warrants to purchase 1,377,147 shares of common stock at between $3.50 and $5.06, options to purchase 1,833,000 shares of common stock at between $0.41 and $5.23, convertible debt of $12,500,000 convertible at $3.65 per share, and other convertible debt of $500,000 convertible at $4.50 per share were outstanding for the year ended December 31, 2005, but were not included in the computation of diluted loss per share because the effect of exercise or conversion would have an antidilutive effect on loss per share. NOTE 11--2005 RESTRUCTURING PLAN In an effort to better align the Company's organizational and cost structures with its future growth opportunities, in August 2005 the Company's Board of Directors adopted a restructuring plan for the Company that was substantially completed by December 2005. The plan included restructuring the Company's global operations by eliminating redundancies in its Hong Kong operation, closing its Mexican facilities, converting its Guatemala facility from a manufacturing site to a distributor, and closing its North Carolina manufacturing facility. The Company also refocused its sales efforts on higher margin products, which may have resulted in lower net sales with certain customers. As a result, the Company now operates with fewer employees and reduced associated operating and manufacturing expenses. The Company recorded charges in connection with its restructuring plan in accordance with SFAS No. 146 (As Amended), "Accounting for Costs Associated with Exit or Disposal Activities." In addition, the Company's restructuring plan resulted in the carrying value of certain long-lived assets, primarily equipment, being impaired. Accordingly, in 2005 the Company recorded a charge to recognize the impairment of these assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets. The North Carolina manufacturing facility is a long-lived asset that is classified as "held for sale" because it meets the criteria listed in Paragraph 30 of SFAS 144. Management has committed to sell the asset, and is listing the property for sale with a commercial real estate agent. The Company believes the sale of the asset is probable and the sale is expected to be completed within one year. The major components of manufacturing equipment used in this plant to manufacture zippers are not classified as held for sale since the Company intends to re-deploy this equipment in the manufacture of TALON zippers through investment or sale of this equipment to its distributors of TALON zippers. This equipment is separately identified as idle equipment as a component of "Property and equipment" which are included in the accompanying consolidated balance sheets (See Note 1). Restructuring costs recorded in 2005 were $6,371,000. Restructuring costs include $3,447,000 of inventory write-downs, restructuring charges of $2,474,000 consisting of $2,036,000 for the impairment of long-lived assets, primarily machinery and equipment, $170,000 of one-time employee termination benefits and other costs of $268,000, which were fully paid by the end of 2005. In addition, an impairment charge to goodwill in the amount of $450,000 was recorded. This goodwill was associated with an acquisition made to benefit the Central and South American operations. Since these operations are being exited, management concluded that this goodwill was impaired and should be written off. These restructuring costs were recorded in the Consolidated Statement of Operations for the year ended December 31, 2005 in the following line items and amounts: Cost of goods sold .... $3,447,000 Operating expenses: General & administrative expenses ... 450,000 Restructuring charges .... 2,474,000 ---------- Total restructuring costs .... $6,371,000 ========== 61 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 12--INCOME TAXES The components of the provision (benefit) for income taxes included in the consolidated statements of operations are as follows: Year Ended December 31, -- 2007 2006 2005 ---------- ---------- ---------- Current: Federal .... $ -- $ 29,900 $ 55,479 State .... 4,360 4,000 4,000 Foreign .... 66,589 -- -- ---------- ---------- ---------- 70,949 33,900 59,479 Deferred: Federal .... -- -- 850,000 State .... -- -- 150,000 ---------- ---------- ---------- -- -- 1,000,000 ---------- ---------- ---------- $ 70,949 $ 33,900 $1,059,479 ========== ========== ========== A reconciliation of the statutory Federal income tax rate with the Company's effective income tax rate is as follows: Year Ended December 31, ---------------------------- 2007 2006 2005 ------ ------ ------ Current: Federal statutory rate .... (34.0)% 34.0% (34.0)% State taxes net of federal benefit .... 1.6 2.3 (5.8) Income earned from foreign subsidiaries ... 54.9 18.7 0.2 Net operating loss valuation allowance adjustments .... 18.4 (71.7) 43.5 Change in effective state tax rate .... (0.1) 22.4 -- Other .... (39.3) 4.2 (0.2) ------ ------ ------ 1.5% 9.9% 3.7% ====== ====== ====== Income (loss) before income taxes is as follows: Year Ended December 31, -- 2007 2006 2005 ------------ ------------ ------------ Domestic .... $(11,827,832) $ (1,341,475) $(28,724,518) Foreign .... 6,977,074 1,684,678 246,288 ------------ ------------ ------------ $ (4,850,758) $ 343,203 $(28,478,230) ============ ============ ============ 62 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS The primary components of temporary differences which give rise to the Company's deferred tax assets and deferred tax liabilities are as follows: Year Ended December 31, ------------------------------ 2007 2006 ------------ ------------ Net deferred tax asset: Net operating loss carry-forwards ..... $ 20,222,679 $ 19,053,346 Depreciation and amortization (liability) .... (899,776) (551,643) Bad debt reserve .... 42,065 17,961 Related party interest .... 200,093 189,605 Inventory reserve .... 265,200 289,813 AMT credit carryforward .... 41,089 -- Other .... 332,420 225,656 ------------ ------------ 20,203,770 19,224,738 Less: Valuation Allowance .... (20,162,681) (19,224,738) ------------ ------------ $ 41,089 $ -- ============ ============ On January 1, 2007 the Company adopted the provisions of Financial Accounting Standard Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on the recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition associated with income tax liabilities. As a result of the implementation of FIN 48, the Company recognized an increase in liabilities for unrecognized tax benefits of approximately $246,000, which was accounted for as an increase in the January 1, 2007 accumulated deficit. A reconciliation of the FIN 48 adjustments is as follows: Balance at Jan 1, 2007 .... $ -- Increase related to positions on items from prior years .... 212,000 Decrease related to positions on items from prior years .... -- Interest and penalty on items from prior years .... 34,000 Increase related to 2007 .... 12,000 -------- Total .... $258,000 ======== At December 31, 2007 and 2006, Talon International, Inc. had Federal and state net operating loss carry-forwards (or "NOLs") of approximately $55.9 million and $53.6 million, respectively. The Federal NOL is available to offset future taxable income through 2025, and the state NOL expires in 2015. Section 382 of the Internal

Revenue Code places a limitation on the realizability of net operating losses in future periods if the ownership of the Company has changed more than 50% within a three-year period. As of December 31, 2007, some of our net operating losses may be limited by the Section 382 rules. The amount of such limitations, if any, has not yet been determined. 63 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax benefit carry-forwards. Deferred tax liabilities and assets at the end of each period are determined using enacted tax rates. The Company records deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if it believes that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. The provisions of SFAS No. 109, "Accounting for Income Taxes," require the establishment of a valuation allowance when, based on currently available information and other factors, it is more likely than not that all or a portion of a deferred tax asset will not be realized. SFAS No. 109 provides that an important factor in determining whether a deferred tax asset will be realized is whether there has been sufficient income in recent years and whether sufficient income is expected in future years in order to utilize the deferred tax asset. In 2007, the Company determined, based upon its cumulative operating losses, that it was more likely than not that it would not be in a position to fully realize all of its deferred tax assets in future years with the exception of the alternative minimum tax credit carryforward of $41,089. In 2006 and in prior years, the Company determined, based upon its cumulative operating losses, that it was more likely than not that it would not be in a position to fully realize all of its deferred tax assets in future years. Accordingly, at December 31, 2007 and 2006 the Company has recorded a valuation allowance of $20.2 million and $19.2 million, respectively; which reduces the carrying value of its net deferred tax assets. For the year ended December 31, 2006 the Company recorded operating income and various rate and tax timing differences and the value of its net deferred tax assets declined by $2.2 million. Accordingly, a corresponding reduction in the valuation allowance was made, which retained the carrying value of the Company's net deferred tax assets at $0. During 2005 the Company incurred additional operating losses which resulted in an increase in the Company's net deferred tax assets by $11.5 million. Accordingly, it was determined that the valuation allowance from 2004 be increased by $12.5 million to $21.4 million, which reduced the carrying value of its net deferred tax assets to $0 at December 31, 2005. The Company intends to maintain a valuation allowance for its deferred tax assets until sufficient evidence exists to support the reversal or reduction of the allowance. At the end of each period, the Company will review supporting evidence, including the performance against sales and income projections, to determine if a release of the valuation allowance is warranted. If in future periods it is determined that it is more likely than not that the Company will be able to recognize all or a greater portion of its deferred tax assets, the Company will at that time reverse or reduce the valuation allowance. The Company believes that its estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change 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 its balance sheet and results of operations. The Company has not provided withholding of U.S. federal income taxes on undistributed earnings of its foreign subsidiaries because the Company intends to reinvest those earnings indefinitely or any taxes on these earnings will be offset by the approximate credits for foreign taxes paid. It is not practical to determine the U.S. federal tax liability, if any, which would be payable if such earnings were not invested indefinitely. At December 31, 2007 and 2006, undistributed earnings from our foreign subsidiaries were $6,286,000 and $4,581,000, respectively. 64 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 13--COMMITMENTS AND CONTINGENCIES OPERATING LEASES The Company is a party to a number of non-cancelable operating lease agreements involving buildings and equipment, which expire at various dates through 2011. The Company accounts for its leases in accordance with SFAS No. 13, whereby step provisions, escalation clauses, tenant improvement allowances, increases based on an existing index or rate, and other lease concessions are accounted for in the minimum lease payments and are charged to the income statement on a straight-line basis over the related lease term. The future minimum lease commitments at December 31, 2007 are as follows: Years Ending December 31, Amount -- ---------- 2008 .... $ 576,611 2009 .... 412,139 2010 .... 240,527 2011

.... 15,468 ---------- Total minimum payments .... $1,244,745 ========== Total rental expense for the years ended December 31, 2007, 2006 and 2005 aggregated $591,312, $640,864, and $750,536, respectively. PROFIT SHARING PLAN In October 1999, the Company established a 401(k) profit-sharing plan for the benefit of eligible employees. The Company may make annual contributions to the plan as determined by the Board of Directors. Total contributions for the years ended December 31, 2007, 2006 and 2005 amounted to $25,494, $22,276, and $16,807, respectively. CONTINGENCIES On December 26, 2007, the Company elected to voluntarily withdraw the listing of its common stock from trading on the American Stock Exchange. The common stock began trading on the OTC Bulletin Board (OTCBB) under the new symbol TALN.OB. On October 12, 2005, a shareholder class action complaint -- HUBERMAN V.TAG-IT PACIFIC, INC., ET al., Case No. CV05-7352 R(Ex) -- was filed against the Company and certain of its current and former officers and directors in the United States District Court for the Central District of California, alleging claims under Section 10(b) and Section 20 of the Securities Exchange Act of 1934. A lead plaintiff was appointed, and his amended complaint alleged that defendants made false and misleading statements about the Company's financial situation and its relationship with certain of its large customers. The action was brought on behalf of all purchasers of the Company's publicly-traded securities during the period from November 13, 2003 to August 12, 2005. On February 20, 2007, the Court denied class certification. On April 2, 2007 the Court granted defendants' motion for summary judgment, and on or about April 5, 2007, the Court entered judgment in favor of all defendants. On or about April 30, 2007, plaintiff filed a notice of appeal, and his opening appellate brief was filed on October 15, 2007. The Company's brief was filed on November 28, 2007. The Company believes that this matter will be resolved favorably on appeal, or in a later trial or in settlement within the limits of its insurance coverage. However, the outcomes of this action or an estimate of the potential 65 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS losses, if any, related to the lawsuit cannot be reasonably predicted, and an adverse resolution of the lawsuit could potentially have a material adverse effect on the Company's financial position and results of operations. 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 the exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. On June 5, 2006 the Court denied our motion for partial summary judgment, but did not find that we breached our agreement with Pro-Fit and a trial is required to determine issues concerning our activities in Columbia and whether other actions by Pro-Fit constituted an unwillingness or inability to fill orders. The Court also held that Pro-Fit was not "unwilling or unable" to fulfill orders by refusing to fill orders with goods produced in the United States. The action is still pending in the United States District Court. The action is presently stayed pending resolution or trial of an earlier filed action between Pro-Fit Holdings and their attorneys who have sued Pro-Fit Holdings and have obtained a judgment. In the past, we had derived a significant amount of revenue from the sale of products incorporating the stretch waistband technology and our business, results of operations and financial condition could be materially adversely affected if the dispute with Pro-Fit is not resolved in a manner favorable to us. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial. The Company currently has pending a number of other claims, suits and complaints that arise in the ordinary course of our business. The Company believes 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 the Company's consolidated financial condition if adversely determined against the Company. In November 2002, the FASB issued FIN No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others - and interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34." The following is a summary of the Company's agreements that it has determined are within the scope of FIN 45: 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 66 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities. NOTE 14--SEGMENT REPORTING AND GEOGRAPHIC INFORMATION The Company specializes in the distribution of a full range of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. There is not enough difference between the types of products developed and distributed by the Company to justify segmented reporting by product type. The Company believes that revenue by each major product class is a valuable business measurement. The net revenues for the three primary product groups are as follows: Year Ended December 31, -- 2007 2006 2005 ----------- ----------- ----------- Product Group Net Revenue: Talon zipper .... $21,159,595 $17,005,203 $13,593,479 Trim .... 18,688,698 22,502,947 24,788,397 Tekfit .... 681,262 9,316,852 8,949,300 ----------- ----------- ----------- $40,529,555 $48,825,002 $47,331,176 =========== =========== =========== The Company distributes its products internationally and has reporting requirements based on geographic regions. Long-lived assets are attributed to countries based on the location of the assets and revenues are attributed to countries based on customer delivery locations, as follows: Year Ended December 31, -- 2007 2006 2005 ----------- ----------- ----------- Sales: United States .... $ 3,692,468 $ 4,223,052 $ 7,052,196 Hong Kong .... 14,178,421 13,650,419 7,901,079 Dominican Republic .... 700,868 8,966,828 150,793 China .... 11,159,726 6,063,416 7,091,034 India .... 2,187,684 1,205,486 809,972 Bangladesh .... 1,924,943 2,070,349 798,699 Mexico .... 783,762 2,476,313 12,945,861 Other .... 5,901,683 10,169,139 10,581,542 ----------- ----------- ----------- Total .... $40,529,555 $48,825,002 $47,331,176 =========== =========== =========== Long-lived Assets: United States .... $ 8,778,381 $ 9,529,932 $ 9,797,111 Hong Kong .... 556,864 336,149 222,467 Dominican Republic .... 558,198 667,238 776,279 Mexico .... 1,072 5,198 23,754 China .... 109,770 49,488 2,633 Other .... 16,912 3,315 1,120 ----------- ----------- ----------- Total .... $10,021,197 $10,591,320 $10,823,364 =========== =========== =========== 67 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 15--MAJOR CUSTOMERS AND VENDORS For the year ended December 31, 2007, the Company's three largest customers represented approximately 9% of consolidated net sales. For the year ended December 31, 2006, no single customer represented more than 9% of the Company's consolidated net sales; however the Company's three largest customers represented approximately 18% of consolidated net sales. For the year ended December 31, 2005, no single customer represented more than 10% of consolidated net sales; however, the Company's three largest customers represented approximately 22% of consolidated net sales. Three vendors, each representing more than 10% of the Company's purchases, accounted for approximately 50% of the Company's purchases for the year ended December 31, 2007. One vendor accounted for substantially all of the Company's purchases associated with its Tekfit product for the year ended December 31, 2007. One major vendor accounted for substantially all of the Company's purchases associated with its Tekfit product for the year ended December 31, 2006 and represented 24% of the Company's overall purchases; and three vendors, each representing more than 10% of the Company's purchases, accounted for approximately 45% of the Company's purchases for the year ended December 31, 2006. Three vendors accounted for approximately 39% of the Company's purchases for the year ended December 31, 2005 Included in accounts payable and accrued expenses at December 31, 2007 and 2006 is $2,239,000 and $2,682,000 due to these vendors. Terms are sight to 60 days. NOTE 16--RELATED PARTY TRANSACTIONS Prior to 2004 the Company operated an apparel trim supply agreement with Tarrant Apparel Group. Two of Tarrant's directors and significant shareholders are also shareholders of the Company. In 2004, following negotiations with

Tarrant Apparel Group, the Company determined that a significant portion of the obligations due from this customer were uncollectible. Accordingly, included in general and administrative expenses for 2004 are charges of $4.3 million related primarily to the write-down of this receivable and leaving a remaining balance receivable from this customer of $4.5 million at December 31, 2004. An affiliate of the customer repaid the $4.5 million receivable balance over the period from May through December 2005. The Company terminated its supply relationship with Tarrant in 2004; however the Company continues to conduct business with Tarrant on a limited basis. Total sales to Tarrant for the years ended December 31, 2007, 2006 and 2005 were $143,000, $3,000, and $574,000, respectively. As of December 31, 2005, accounts receivable, related party included $0.05 million due from Tarrant. No amounts were due from Tarrant at December 31, 2007 and 2006. Colin Dyne, a director and stockholder of the Company is also a director, officer and significant shareholder in People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. During 2007 and 2006 the Company had sales of $241,000 and $147,000, respectively, to Versatile Entertainment. Accounts receivable of $44,000 and $83,400 were outstanding from Versatile Entertainment at December 31, 2007 and 2006, respectively. Due from related parties at December 31, 2007 and 2006 includes $625,454 and $675,137, respectively, of unsecured notes, advances and accrued interest receivable from Colin Dyne. The notes and advances bear interest at 7.5% and are due on demand. During 2007 certain notes payable due to Mr. Dyne were offset against and used to satisfy notes receivable from Mr. Dyne. 68 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Demand notes payable to related parties includes notes and advances to Mark Dyne, the Chairman of the Board of Directors of the Company or to parties related to or affiliated with Mark Dyne. The balance of Demand notes payable to related parties at December 31, 2007 and 2006 was $85,176 and 664,971, respectively. See Note 4 for further discussion of these notes, and related accrued interest and interest expense. Jonathan Burstein, a former director of the Company, purchases products from the Company through an entity operated by his spouse. For the years December 31, 2007 and 2006, sales to this entity were $88,491 and $7,342, respectively. At December 31, 2007 and 2006, accounts receivable included $28,657 and $2,223, respectively, due from this entity. On October 25, 2007, Mr. Burstein resigned as a director of the Company. Consulting fees of $291,000 were paid for services provided by Jonathan Burstein for the year ended December 31, 2007. During the fourth quarter of 2007 the Company decided to terminate the consulting agreements of Mr. Burstein and another consultant. In accordance with SFAS No. 146, ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES ("SFAS 146"), the Company calculated the fair value of monthly compensation of the two contracts and recorded an accrual of $538,000 at December 31, 2007 to reflect the liability for consulting costs that would continue to be incurred under their remaining terms. Consulting fees paid to Diversified Investments, a company owned by Mark Dyne, amounted to $150,000 for each of the years ended December 31, 2007, 2006 and 2005. Consulting fees of $304,000 and $335,000 were paid for services provided by Colin Dyne, for the years ended December 31, 2007 and 2006, respectively. Brent Cohen and Raymond Musci, both members of the Board of Directors were paid for services provided during the year ended December 31, 2005 in the amount of $24,000, and $21,000, respectively. NOTE 17--QUARTERLY RESULTS (UNAUDITED) Quarterly results for the years ended December 31, 2007 and 2006 are reflected below: 4TH 3RD 2ND 1ST ------------ ------------ ------------ ------------ 2007 ---- Revenue .... $ 8,859,322 $ 9,013,135 $ 13,566,981 $ 9,090,117 Gross profit .... $ 2,858,913 $ 2,526,476 $ 4,017,731 $ 2,703,615 Operating income (loss) .... $ (379,737) $ (3,055,289) $ 878,009 $ (613,662) Net Income(loss) .... $ (935,025) $ (3,681,831) $ 490,493 $ (795,344) Basic income (loss) per share ..... $ (0.05) $ (0.18) $ 0.03 $ (0.04) Diluted income (loss) per share ... $ (0.05) $ (0.18) $ 0.02 $ (0.04) 2006 ---- Revenue .... $ 10,573,755 $ 13,366,944 $ 14,246,087 $ 10,638,216 Gross profit .... $ 3,350,600 $ 4,148,406 $ 4,127,237 $ 2,842,725 Operating income (loss) .... $ 248,177 $ 630,273 $ 895,281 $ (442,275) Net Income(loss) .... $ 44,950 $ 339,115 $ 654,643 $ (729,404) Basic and diluted income (loss) per per share .... $ 0.00 $ 0.02 $ 0.04 $ (0.04) 69 TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS During 2007 and 2006, the Company had no material unusual or infrequently occurring items or adjustments that were recognized during the years. Quarterly and year-to-date computations of per share amounts are made independently. Therefore, the sum of per share amounts for the quarters may not agree with the per share amounts for the year. NOTE 18 - SUBSEQUENT EVENTS As noted in Note 2 - Marketable Securities, the Company finalized an arrangement between the Company and Azteca Production International, Inc. a former distributor of Talon products on December 31, 2007. The agreement called for Azteca to deliver 2 million shares of common stock in a related company in exchange for cancellation of an outstanding note from Azteca that was in default. On January 16, 2008, Azteca delivered restricted shares to the Company which the Company returned. On January 30, 2008, the Company was notified that unrestricted shares had been delivered by Azteca and that the Company could begin trading these shares selling no more than 2 thousand shares a day. The stock price on January 30, 2008 was used to value the shares. The value of the common stock on April 10, 2008 had decreased $340,000 to $700,000. Effective January 15, 2008, Wouter van Biene resigned his position as the Company's Chief Operating Officer. In connection with Mr. van Biene's resignation and in exchange for a full release of claims against the Company, we have agreed to pay Mr. van Biene twelve months of his current base salary and provide him twelve months of continued coverage under our group health plan. Approximately $0.3 million in severance costs were recognized in January 2008. Effective February 4, 2008, Stephen Forte resigned his position as the Company's Chief Executive Officer and as a member of the Board of Directors and from all positions with the Company's subsidiaries. In connection with Mr. Forte's resignation, on February 4, 2008, the Company entered into a Separation Agreement with Mr. Forte. The Separation Agreement further provides for the payment to Mr. Forte of the same severance benefits he would have received under his employment agreement had the Company terminated Mr. Forte's employment without cause. In exchange for his severance, Mr. Forte has released all claims against the Company. Approximately $0.4 million in severance costs were recognized in January 2008. Also effective February 4, 2008, Lonnie D. Schnell, Chief Financial Officer, was appointed Chief Executive Officer to replace Mr. Forte. On March 27, 2008 Larry Dyne was appointed Executive Vice President of Global Sales and David Hunter was appointed Vice President, Corporate Controller and Principal Accounting Officer. On April 3, 2008 the Company executed an amendment to the existing revolving credit and term loan agreement with Bluefin Capital. The amendment provided for an amendment of the EBITDA and other financial covenants, and the redemption of the stock warrants previously issued to Bluefin Capital in exchange for the issuance of an additional note payable to Bluefin Capital for $1.0 million at an interest rate of 8.5%. The Company will record a reduction to equity and an increase to notes payable for the fair value of the warrants redeemed. The difference between the fair value of the warrants of $221,723 and the face value of the note will be accreted over the life of the note. The note will incur interest at 8.5% on the principal amount of $1.0 million and the quarterly accretion will also be reflected as interest expense. The additional note and all accrued interest under the note are due and payable on June 30, 2010. The Company's borrowing base was also modified 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 by increasing the percentage of accounts receivable to be included in the borrowing base 75% to 85%. 70 ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE None. ITEM 9A(T). 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 Stephen P. Forte, our former principal executive officer, and Lonnie D. Schnell, our principal financial officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, Mr. Forte and Mr. Schnell concluded that these disclosure controls and procedures were effective as of the end of the period covered in this Annual Report on Form 10-K. MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. In order to evaluate the effectiveness of internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act, the Company's management has conducted an assessment, including testing, using the criteria in INTERNAL CONTROL - INTEGRATED FRAMEWORK, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Our system of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Based on its assessment, our management has concluded that control over financial reporting was effective as of December 31, 2007. This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report. CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the fourth quarter of our fiscal year ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. 71 ITEM 9B. OTHER INFORMATION None. PART III ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE The following table sets forth the name, age and position of each of our executive officers and directors as of March 17, 2008. NAME AGE POSITION ---- --- -------- Mark Dyne (1)......... 47 Chairman of the Board of Directors Colin Dyne (1)......... 45 Vice Chairman of the Board of Directors Brent Cohen............ 49 Director Joseph Miller.......... 44 Director Raymond Musci .... 47 Director William Sweedler....... 41 Director Lonnie D. Schnell...... 58 Chief Executive Officer & Chief Financial Officer Larry Dyne............. 35 Executive Vice President, Sales David A. Hunter........ 42 Vice President, Corporate Controller ---------- (1) Colin Dyne and Mark Dyne are brothers. CLASS II DIRECTORS: TERMS EXPIRING IN 2008 There are currently three vacancies among the Class II Directors. CLASS III DIRECTORS: TERMS EXPIRING IN 2009 MARK DYNE Mr. Dyne has served as Chairman of the Board of Directors since 1997. Mr. Dyne currently serves as the Chief Executive Officer and the Managing Partner of Europlay Capital Advisors, LLC, a merchant banking and advisory firm. Mr. Dyne previously served as Chairman and Chief Executive Officer of Sega Gaming Technology Inc. (USA), a gaming company, and Chairman and Chief Executive Officer of Virgin Interactive Entertainment Ltd., a distributor of computer software programs and video games based in London, England. Mr. Dyne was a founder and director of Packard Bell NEC Australia Pty. Ltd., a manufacturer and distributor of personal computers through the Australian mass merchant channel, and he was a founder and former director of Sega Ozisoft Pty Ltd., a leading distributor of entertainment software in both Australia and New Zealand. MEMBER: NOMINATING AND GOVERNANCE COMMITTEES 72 COLIN DYNE Currently, Mr. Dyne serves as Vice Chairman of the Board of Directors. Mr. Dyne founded Tag-It, Inc., one of our subsidiaries, in 1991 with his father, Harold Dyne. Mr. Dyne served as our President from inception and as our Chief Executive Officer from 1997 to 2005. Before founding Tag-It, Inc. in 1991, Mr. Dyne worked in numerous positions within the stationery products industry, including owning and operating retail stationery businesses and servicing the larger commercial products industry through contract stationery and printing operations. RAYMOND MUSCI Ray Musci has served as a Director of the Company since June 2005. Mr. Musci serves as a Director and President of MPLC, Inc. (OTCBB:MPNC) , a publicly traded company that develops, publishes and distributes mobile entertainment services and products. From October 1999 to June 2005, Mr. Musci served as the President and Chief Executive Officer and a director of BAM! Entertainment, Inc., a publicly traded company that develops, publishes and distributes entertainment software products and video games. Mr. Musci currently serves as a director of Brilliant Digital Entertainment, Inc., a publicly traded corporation (OTCBB: BDEI). From May 1990 to July 1999, Mr. Musci served as the President, Chief Executive Officer and as a director of Infogrames Entertainment, Inc. (formerly Ocean of America, Inc.), a company that develops, publishes and distributes software products. Mr. Musci also previously served as a director of Ocean International, Ltd., the holding company of Ocean of America, Inc. and Ocean Software, Ltd., and as Executive Vice President/General Manager of Data East USA, Inc., a subsidiary of Data East Corp., a Japanese company. MEMBER: AUDIT AND COMPENSATION COMMITTEES CLASS I DIRECTORS: TERMS EXPIRING IN 2007 JOSEPH MILLER Mr. Miller has served on the Board of Directors since June 2005. Since 2003, he has been a Managing Director of Europlay Capital Advisors, LLC, a merchant banking and advisory firm. From 1998 to 2003, Mr. Miller was a Senior Vice President at Houlihan Lokey Howard & Zukin, a leading middle-market investment bank. From 1994 to 1998, Mr. Miller served as the Vice President, Corporate Development for Alliance Communications Corporation, Canada's leading independent producer and distributor of filmed entertainment. Mr. Miller has bachelor's degree in Economics and Business from the University of California, Los Angeles MEMBER: AUDIT COMMITTEE BRENT COHEN Mr. Cohen has served on the Board of Directors since 1998. Mr. Cohen has served as Chief Executive Officer and a director of Dovebid Inc. since August 2005. Mr.

Cohen served as President and was a member of the Board of Directors of First Advantage Corporation (formed by the merger of US Search and First American Financial screening companies) from June 2003 to 2005. Mr. Cohen served as Chairman of the Board, President and Chief Executive Officer of US Search from February 2000 until June 2003. Mr. Cohen previously held various management positions in both the management consulting and auditing practice of Arthur Young & Company (now Ernst & Young). Mr. Cohen holds a Bachelor of Commerce degree, a Graduate Diploma in Accounting and an MBA from the University 73 of Cape Town in South Africa. He is also a chartered accountant. MEMBER: COMPENSATION, NOMINATING AND GOVERNANCE COMMITTEES WILLIAM SWEEDLER Mr. Sweedler has served on the Board of Directors since 2006. He is presently Chairman & CEO of Windsong Allegiance Group, a diversified brand management and operating company that specializes in the acquisition, development, licensing, and comprehensive creative management of consumer branded intellectual property. The company owns and licenses the brands, Como Sport, Calvin Klein Golf, Joseph Abboud Golf, and PRX. Mr. Sweedler previously served as President & CEO of Joe Boxer, a wholly owned division of the Iconix Brand Group (NASDAQ: ICON) of which he was Executive Vice President and member of the Board of Directors during 2005 to June 2006. Prior to Mr. Sweedler joining Iconix Brand Group, he was CEO & President of Windsong Allegiance Apparel Group from 2001 to 2005. The company owned, managed, and licensed the brands Joe Boxer, Hathaway, New Frontier, Pivot Rules, Alexander Julian, Geoffrey Beene, Ron Chereskin, and Hawaiian Tropic. In 1995, Mr. Sweedler co-founded, Windsong, Inc., a full service apparel operating and marketing company. Prior to Windsong, he worked as a Regional Account Manager at Polo Ralph Lauren. He graduated from Babson College with a B.S. in Finance & Investments in 1988. He has served as a public director at Iconix Brand Group and Bank of Westport as well as numerous private organizations. MEMBER: AUDIT AND COMPENSATION COMMITTEES OTHER EXECUTIVE OFFICERS LONNIE D. SCHNELL Mr. Schnell joined the Company in January 2006 as our Chief Financial Officer, and was appointed as Chief Executive Officer in February 2008. Mr. Schnell served as Vice President of Finance for Capstone Turbine Corporation, a manufacturer of micro-turbine electric generators from 2004 until 2005. From 2002 to 2004 Mr. Schnell served as Chief Financial Officer of EMSource, LLC, an electronic manufacturing service company. Prior to EMSource, in 2002, Mr. Schnell served as Chief Financial Officer of Vintage Capital Group, a private equity investment firm. From 1999 through 2002, Mr. Schnell served as Chief Financial Officer of Need2Buy, Inc. a business-to-business internet marketplace for electronic components. Mr. Schnell has completed an executive MBA program with the Stanford University Executive Institute, and earned his Bachelor of Science in Accounting at Christian Brothers University. Mr. Schnell is a Certified Public Accountant with experience in the international accounting firm of Ernst & Young LLP. LARRY DYNE Larry Dyne was appointed Executive Vice President of Sales in February 2008. He has been an employee of our company since 1992, and was formerly vice president of product development and global sourcing, as well as vice president of trim sales. Through these positions, Mr. Dyne has established extensive and long-term relationships with the world's top brands and clothing retailers. He was also formerly responsible for domestic production for all printing. 74 DAVID A. HUNTER David Hunter was appointed Vice President, Corporate Controller (and as our principal accounting officer) in February 2008. Mr. Hunter has extensive experience in both public and private accounting and joined Talon in December 2007 as the Corporate Controller. Prior to Talon, he served as the director of accounting and financial reporting for Walt Disney Studios. Before Disney, he served as a manager of accounting and analysis at WellPoint's Blue Cross of California division in its individual and small group practice before joining its financial operations practice. He is a certified public accountant with experience in the international accounting firm of Deloitte & Touche LLP, where he served as a manager in the audit and assurance practice. Mr. Hunter earned his Bachelor of Science in Accounting at California Lutheran University. AUDIT COMMITTEE; AUDIT COMMITTEE FINANCIAL EXPERT We currently have a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The Audit Committee currently consists of Raymond Musci, Joseph Miller and William Sweedler. The Board of Directors has further determined that Mr. Musci is an "audit committee financial expert" as such term is defined in Item 401(h) of Regulation S-K promulgated by the SEC. SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE Section 16(a) of the Securities Exchange Act of 1934 requires our executive officers, directors, and persons who own more than ten percent of a registered class of our equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Executive officers, directors and greater-than-ten percent stockholders are required by Securities and Exchange Commission regulations to furnish the Company with all Section 16(a) forms they file. Based solely on our review of the copies of the forms received by us and written representations from certain reporting persons that they have complied with the relevant filing requirements, we believe that, during the year ended December 31, 2007, all of our executive officers, directors and greater-than-ten percent shareholders complied with all Section 16(a) filing requirements, except for the following: (i) three Statements of Changes in Beneficial Ownership on Form 4, reporting nine transactions, were filed late by Colin Dyne; (ii) one Annual Statement of Changes in Beneficial Ownership on Form 5, reporting five transactions, was filed late by Jonathan Burstein; and (iii) one Statement of Change in Beneficial Ownership on Form 4, reporting two transactions, was filed late by Bluefin Capital LLC. CODE OF ETHICS We have adopted a Code of Ethical Conduct that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as well as to our other employees and directors generally. A copy of our Code of Ethical Conduct was filed as an exhibit to our Annual Report on Form 10-K. 75 ITEM 11. EXECUTIVE COMPENSATION COMPENSATION DISCUSSION AND ANALYSIS Talon International Inc.'s executive compensation program is administered by the Compensation Committee of our Board of Directors, or referred to in this section as the "Committee." The Committee is responsible for, among other functions: (1) reviewing and approving corporate goals and objectives relevant to the Chief Executive Officer's compensation and evaluating the performance of the Chief Executive Officer in light of these corporate goals and objectives; (2) reviewing and making recommendations to the Board of Directors with respect to the compensation of other executive officers; (3) administering our incentive-compensation and equity based plans, which may be subject to the approval of the Board of Directors; and (4) negotiating, reviewing and recommending the annual salary, bonus, stock options and other benefits, direct and indirect, of the Chief Executive Officer, and other current and former executive officers. The Committee also has the authority to select and/or retain outside counsel, compensation and benefits consultants, or any other consultants to provide independent advice and assistance in connection with the execution of its responsibilities. Our named executive officers for 2007 were as follows: o Stephen P. Forte, former Chief Executive Officer (resigned as of February 4, 2008); o Wouter van Biene, former Chief Operating Officer (resigned as of January 15, 2008); and o Lonnie D. Schnell, Chief Financial Officer (named Chief Executive Officer as of February 4, 2008) COMPENSATION PHILOSOPHY Our executive compensation program is designed to drive company performance to maximize shareholder value while meeting our needs and the needs of our employees. The specific objectives of our executive compensation program include the following: o ALIGNMENT - to align the interests of executives and shareholders through equity-based compensation awards; o RETENTION - to attract, retain and motivate highly qualified, high performing executives to lead our continued growth and success; and o PERFORMANCE - to provide rewards commensurate with performance by emphasizing variable compensation that is dependant upon the executive's achievements and company performance. In order to achieve these specific objectives, our executive compensation program is guided by the following core principles: o Rewards under incentive plans are based upon our short-term and longer-term financial results and increasing shareholder value; o Senior executive pay is set at sufficiently competitive levels to attract, retain and motivate highly talented individuals who are necessary for us to achieve our goals, objectives and overall financial success; 76 o Compensation of an executive is based on such individual's role, responsibilities, performance and experience, taking into account the desired pay relationships within the executive team; and o Our executive compensation program places a strong emphasis on performance-based variable pay to ensure a high pay-for-performance culture. Annual performance of our company and the executive are taken into account in determining annual bonuses that ensures a high pay-for-performance culture. COMPENSATION ELEMENTS We compensate senior executives through a variety of components, including base salary, annual incentives, equity incentives, and benefits and perquisites, in order to provide our employees with a competitive overall compensation package. The mix and value of these components are impacted by a variety of factors, such as responsibility level, individual negotiations and performance and market practice. The purpose and key characteristics for each component are described below. BASE SALARY Base salary provides executives with a steady income stream and is based upon the executive's level of responsibility, experience, individual performance and contributions to our overall success. Competitive base salaries, in conjunction with other pay components, enable us to attract and retain highly talented executives. The Committee typically sets base salaries for our senior executives at market levels. However, base salaries will vary in practice based upon an individual's performance, individual experience and negotiations and for changes in job responsibilities. ANNUAL INCENTIVE BONUSES Annual incentive bonuses are a variable performance-based component of compensation. The primary objective of an annual incentive bonus is to reward executives for achieving corporate and individual goals and to align a meaningful portion of total pay opportunities for executives and other key employees to the attainment of our company's performance goals. Annual incentive awards are also used as a means to recognize the contribution of our executive officers to overall financial, operational and strategic success. EQUITY INCENTIVES Equity incentives are intended to align senior executive and shareholder interests by linking a meaningful portion of executive pay to long-term shareholder value creation and financial success over a multi-year period. Equity incentives are also provided to our executives to attract and enhance the retention of executives and other key employees and to facilitate stock ownership by our senior executives. The Committee also considers individual and company performance when determining long-term incentive opportunities. HEALTH & WELFARE AND 401-K BENEFITS The named executive officers participate in a variety of retirement, health and welfare, and paid time-off benefits designed to enable us to attract and retain our workforce in a competitive marketplace. Health and welfare and paid time-off benefits help ensure that we have a productive and focused workforce. 77 SEVERANCE AND CHANGE OF CONTROL ARRANGEMENTS We do not have a formal plan for severance or separation pay for our employees, but we typically include a severance provision in the employment agreements of our executive officers that is triggered in the event of involuntary termination without cause or in the event of a change in control. In order to preserve the morale and productivity and encourage retention of our key executives in the face of the disruptive impact of an actual or rumored change in control, we provide a bridge to future employment in the event that an executive's job is eliminated as a consequence of a change in control. This provision is intended to align executive and shareholder interests by enabling executives to consider corporate transactions that are in the best interests of the shareholders and other constituents without undue concern over whether the transactions may jeopardize the executive's own employment. Our employment agreements with our current named executive officers provide a lump sum payment and benefits continuation as a result of an involuntary termination without cause or for good reason following a change in control, plus accelerated vesting of stock or option awards. OTHER BENEFITS In order to attract and retain highly qualified executives, we provide some of our named executive officers, including our former CEO, with automobile allowances that we believe are consistent with current market practices. Our executives also may participate in a 401(k) plan under which we match contributions for all employees up to 100% of an employee's contributions to a maximum of $1,000 and subject to any limitations imposed by ERISA. OTHER FACTORS AFFECTING COMPENSATION ACCOUNTING AND TAX CONSIDERATIONS We consider the accounting implications of all aspects of our executive compensation program. Our executive compensation program is designed to achieve the most favorable accounting (and tax) treatment possible as long as doing so does not conflict with the intended plan design or program objectives. PROCESS FOR SETTING EXECUTIVE COMPENSATION When making pay determinations for named executive officers, the Committee considers a variety of factors including, among others: (1) actual company performance as compared to pre-established goals, (2) overall company performance and size relative to industry peers, (3) individual executive performance and expected contribution to our future success, (4) changes in economic conditions and the external marketplace and (5) in the case of named executive officers, other than Chief Executive Officer, the recommendation of our Chief Executive Officer. Ultimately, the Committee uses its judgment when determining how much to pay our executive officers. The Committee evaluates each named executive officer's performance during the year against established goals, leadership qualities, business responsibilities, current compensation arrangements and long-term potential to enhance shareholder value. The opinions of outside consultants are also taken into consideration in deciding what salary, bonus, long-term incentives and other benefits and severance to give each executive in order to meet our objectives stated above. The Committee considers, compensation information from data gathered from annual reports and proxy statements from companies that the Committee generally considers comparable to our Company; compensation of other Company employees for internal pay equity purposes; and levels of other executive compensation plans from compensation surveys. The Committee sets the pay for the named executive officers and other executives, by element and in the aggregate, at levels that it believes are competitive and necessary to attract and retain talented executives capable of achieving the Company's long-term objectives. 78 FACTORS CONSIDERED In administering the compensation program for senior executives, including named executive officers, the Committee considers the following: o CASH VERSUS NON-CASH COMPENSATION. The pay elements are cash-based except for the long-term incentive program, which is equity-based. In 2007, the long-term incentive program for the named executive officers consisted entirely of previously granted stock grants and option awards that vest in installments over a one to four year period from the date of grant; o PRIOR YEAR'S COMPENSATION. The committee considers the prior year's bonuses and long-term incentive awards when approving bonus payouts or equity grants; o ADJUSTMENTS TO COMPENSATION. On an annual basis, and in connection with setting executive compensation packages, the Committee reviews our operating income growth, earnings before interest and taxes growth, earnings per share growth, cash flow growth, operating margin, revenue growth, and total shareholder return performance. In addition, the Committee considers peer group pay practices, emerging market trends and other factors. No specific weighing is assigned to these factors nor are particular targets set for any particular factor. Total compensation from year to year can vary significantly based on our and the individual executive's performance. The base compensation of our former Chief Executive Officer during 2007 was $325,000 annually in accordance with the provisions in his employment contract. o APPLICATION OF DISCRETION. It is our policy and practice to use discretion in determining the appropriate compensation levels considering performance. REPORT OF COMPENSATION COMMITTEE The Compensation Committee of our Board of Directors consists of Brent Cohen, Raymond Musci and William Sweedler. The Compensation Committee is responsible for considering and making recommendations to the Board of Directors regarding executive compensation and is responsible for administering the Company's stock option and executive incentive compensation plans. The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis included in this report. Based on the review and discussion with management, the Compensation Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in the Company's Annual Report on Form 10-K. COMPENSATION COMMITTEE Brent Cohen Raymond Musci William Sweedler April 11, 2008 79 EXECUTIVE COMPENSATION SUMMARY COMPENSATION TABLE The following table sets forth, as to each person serving as Chief Executive Officer and Chief Financial Officer during 2007, and the one highly compensated executive officer other than the Chief Executive Officer and Chief Financial Officer who were serving as executive officers at the end of the 2007 whose compensation exceeded $100,000 (referred to as "named executive officers"), information concerning all compensation earned for services to us in all capacities for 2007. NON-EQUITY INCENTIVE STOCK OPTION PLAN ALL OTHER NAME AND SALARY AWARDS AWARDS COMPENSATION COMPENSATION TOTAL PRINCIPAL POSITION YEAR ($) ($)(4) ($)(4) ($) ($)(5) ($) ------------------------------ ------- ------- ------- ------- ----------- ----------- ------- Lonnie D. Schnell (1) .... 2007 225,000 -- 1,917 45,000 11,343 283,260 Chief Executive Officer and .. 2006 171,346 -- 31,998 45,025 24,634 273,003 Chief Financial Officer Stephen P. Forte (2) .... 2007 325,000 -- 7,851 -- 30,484 363,335 Former Chief Executive .... 2006 275,000 77,468 73,995 90,050 35,497 552,010 Officer Wouter van Biene (3) .... 2007 225,000 -- 1,986 -- 11,502 238,488 Former Chief Operating Officer 2006 180,000 -- 27,526 45,025 7,006 259,557 ---------- (1) Mr. Schnell was appointed Chief Executive Officer effective February 4, 2008. (2) Mr. Forte resigned as Chief Executive Officer effective February 4, 2008. (3) Mr. van Biene resigned as Chief Operating Officer effective January 15, 2008. (4) The amounts in this column represent the dollar amounts recognized for financial statement reporting purposes in fiscal 2007 and 2006 with respect to stock awards and options granted in the applicable year as well as prior fiscal years in accordance with SFAS No. 123(R). Pursuant to SEC rules, the amounts shown exclude the impact of estimated forfeitures related to service-based vesting conditions. For additional information on the valuation assumptions with respect to these grants, refer to Note 9 to our Consolidated Financial Statements in this Annual Report on Form 10-K. These amounts do not reflect the actual value that may be realized by the named executive officers which depends on the value of our shares in the future. (5) All other compensation consists of the following (amounts in dollars): MR. SCHNELL MR. FORTE MR. VAN BIENE -------------- -------------- -------------- 2007 2006 2007 2006 2007 2006 ------ ------ ------ ------ ------ ------ Health & medical insurance (a) .... 11,019 12,673 8,202 12,916 11,178 6,925 Life & disability insurance (b) .... 324 81 4,282 81 324 81 Automobile allowances .... -- -- 18,000 22,500 -- -- Consulting services (c) .. -- 11,880 -- -- -- -- ------ ------ ------ ------ ------ ------ Total .... 11,343 24,634 30,484 35,497 11,502 7,006 ====== ====== ====== ====== ====== ====== ---------- (a) Includes payments of medical premiums. (b) Includes executive and group term life insurance. (c) Represents fees for services provided prior to employment. EXECUTIVE COMPENSATION The 2007 compensation for our former Chief Executive Officer was in accordance with our employment agreement completed with Mr. Forte in March 2006. The terms and conditions established in this agreement were the result of our consideration of our 2005 operating performance, our 2005 Restructuring and Strategic Plan and current operating performance levels, as well as the compensation levels for our previous CEO, comparative industry compensation levels, and negotiations with Mr. Forte. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies, and a long-term equity option of 900,000 shares of common stock, representing approximately 4.9% of our outstanding shares, was established as an inducement to maximum performance achievements and increased shareholder values. The option grant was established to vest monthly over a three-year term, after a minimum initial term of twelve months, to coincide with the objectives of our Strategic Plan. In addition to the long-term equity incentive, a cash incentive, a Management Incentive Program 80 ("MIP"), was established as provided in Mr. Forte's employment agreement setting aside 15% of the Company's earnings before interest and taxes ("EBIT") for annual bonus awards to Mr. Forte and the other senior executives. One-half of this MIP Fund was allocated to Mr. Forte in 2006 and is shown in the table above as non-equity incentive plan compensation, and one-third of the MIP fund is to be allocated to Mr. Forte in 2007 through 2009. MIP Funds were not distributed in 2007 due the operating performance of the Company, however, a discretionary bonus was granted to Mr. Schnell as approved by the Board of Directors. In addition, Mr. Forte was provided a stock grant of 135,135 shares, and an additional option grant, vesting in one year, for 135,135 shares of common stock, in consideration of his significant contributions in the initial development and implementation of the Company's 2005 Restructuring Plan, and the development of the Company's Strategic Plan. Messrs. van Biene and Schnell were employed early in 2006 at the recommendation of Mr. Forte, our former Chief Executive Officer, to assist in the completion of the 2005 Restructuring and Strategic Plan. The terms and conditions established in their employment agreements were also the result of our consideration of our 2005 operating performance, our 2005 Restructuring and Strategic Plan and current operating performance levels, as well as our previous compensation levels for similar positions, comparative industry compensation levels, and individual negotiations. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation for their positions was established near minimum industry levels for the same role in comparable companies, and long-term equity incentives in the form of grants of options to purchase 325,000 shares to Mr. van Biene and 400,000 shares to Mr. Schnell, were established as an inducement to maximum performance achievements and increased shareholder values. The options vest monthly over a three-year term for Mr. van Biene, and a four-year term for Mr. Schnell, after a minimum initial term of twelve months, to coincide with the objectives of the Company's Strategic Plan. In addition Mr. van Biene and Mr. Schnell are participants in the MIP fund established by us as described above, pursuant to which we set aside 15% of our EBIT for annual bonus awards to the CEO and the other senior executives as approved by the Board of Directors. The payments allocated to Mr. van Biene and Mr. Schnell under the MIP fund are shown in the summary compensation table as non-equity incentive plan compensation. GRANTS OF PLAN-BASED AWARDS IN FISCAL 2007 There were no stock option grants to named executive officers during 2007. 81 OUTSTANDING EQUITY AWARDS AT FISCAL YEAR 2007 The following table provides information with respect to outstanding stock options held by each of the named executive officers as of December 31, 2007. NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS ----------------------------- OPTION OPTION (#) (#) EXERCISE EXPIRATION NAME GRANT DATE EXERCISABLE UNEXERCISABLE PRICE ($) DATE ------------------------ ------------ ------------ ------------ ------------ ------------ Lonnie D. Schnell .... 1/26/06 191,667 208,333 (1) $ 0.59 1/26/2016 Stephen P. Forte .... 1/16/06 135,135 -- $ 0.37 1/16/2016 1/16/06 650,000 250,000 (2) $ 0.37 1/16/2016 Wouter van Biene .... 3/1/06 198,611 126,389 (3) $ 0.53 3/1/2016 ---------- (1) Mr. Schnell's options become exercisable with regard to 100,000 shares on January 26, 2007 and then with respect to 8,333 shares per month until fully vested. (2) Mr. Forte's options become exercisable at 25,000 shares per month until fully vested. Mr. Forte resigned as of February 4, 2008, and the vesting of the outstanding options was fully accelerated pursuant to the separation agreement described below under "Employment Agreement, Termination of Employment and Change of Control Agreements." (3) Mr. van Biene's options became exercisable with regard to 108,333 shares on March 1, 2007 and then with respect to 9,028 shares per month until fully vested. Mr. van Biene resigned as of January 15, 2008, and he received 12 months accelerated vesting of outstanding options in accordance with his separation arrangement. EMPLOYMENT AGREEMENTS, TERMINATION OF EMPLOYMENT AND CHANGE OF CONTROL ARRANGEMENTS EMPLOYMENT AGREEMENTS We have entered into the following employment agreements with our named executive officers. LONNIE D. SCHNELL, CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER. On March 16, 2006, we entered into an employment agreement with Lonnie Schnell, pursuant to which Mr. Schnell serves as our Chief Financial Officer on an "at-will" basis. Pursuant to this offer letter, as amended, Mr. Schnell is entitled to receive an annual base salary of $185,000 and will be eligible to receive an annual incentive bonus based upon our earnings before interest and taxes. In October 2006, Mr. Schnell's annual base salary was increased to $225,000 as recognition for superior performance and individual contributions to the achievement to Company objectives. In the event that Mr. Schnell's employment is terminated by us without "cause" (as defined in the agreement) or due to Mr. Schnell's death or disability, then Mr. Schnell or his estate will be entitled to receive as severance, in addition to all accrued salary, (i) salary continuation and continuation of coverage under our group health plan for a period of twelve months and (ii) twelve months acceleration of vesting of all outstanding options. In connection with the offer letter and as an inducement to employment, we previously granted Mr. Schnell an option to purchase 400,000 shares of our common stock, which vests over a period of four years. Upon a change of control of our company, 50% of Mr. Schnell's then-outstanding unvested stock options shall vest and the remaining unvested options shall vest in full if Mr. Schnell is terminated, his position or base pay is reduced or he is required to relocate within six months before or twelve months following the change of control. As of February 4, 2008, Mr. Schnell was also named Chief Executive Officer. STEPHEN FORTE, FORMER CHIEF EXECUTIVE OFFICER. On March 16, 2006, we entered into an Executive Employment Agreement with Stephen Forte, pursuant to which Mr. Forte served as our Chief Executive Officer. This employment agreement had a term continuing though December 31, 2008, which could be extended to 82 December 31, 2009. Pursuant to this agreement, Mr. Forte received an annual base salary of $275,000 for 2006 and $325,000 for each subsequent year of the term and was entitled to receive an annual incentive bonus based upon our earnings before interest and taxes. In the event that prior to the end of the term, Mr. Forte's employment was terminated by us "without cause" (as defined in the agreement), by Mr. Forte for "good reason" (as defined in the agreement) or due to Mr. Forte's death or disability, then Mr. Forte or his estate would be entitled to receive, in addition to all accrued salary, (i) severance payments equal to Mr. Forte's base salary for the remaining term of the agreement or, in the case of death or disability, through December 31, 2008, (ii) a pro rated portion of the annual incentive bonus for the year in which the termination occurred, (iii) full acceleration of vesting of the options issued to Mr. Forte pursuant to the agreement and (iv) continued healthcare coverage for Mr. Forte and his dependents for the remaining term of the agreement. Effective February 4, 2008, Stephen Forte resigned his position as our Chief Executive Officer and as a member of our Board of Directors, as well from all positions with our subsidiaries. In connection with Mr. Forte's resignation, on February 4, 2008, we entered into a Separation Agreement with Mr. Forte. The Separation Agreement further provides for the payment to Mr. Forte of the same severance benefits he would have received under his employment agreement had we terminated Mr. Forte's employment without cause. In exchange for his severance, Mr. Forte has released all claims against us. WOUTER VAN BIENE, FORMER CHIEF OPERATING OFFICER. On March 16, 2006, we entered into an employment agreement with Wouter van Biene, pursuant to which Mr. van Biene serves as our Chief Operating Officer on an "at-will" basis. Pursuant to this offer letter, Mr. van Biene is entitled to an annual base salary of $225,000 and will be eligible to receive an annual incentive bonus based upon our earnings before interest and taxes. In the event that Mr. van Biene's employment is terminated by us without "cause" (as defined in the agreement) or due to Mr. van Biene's death or disability, then Mr. van Biene or his estate will be entitled to receive as severance, in addition to all accrued salary, (i) salary continuation and continuation of coverage under our group health plan for a period of six months if the termination occurs during the first year of employment, a period of twelve months if the termination occurs during the second year of employment or a period of eighteen months if the termination occurs after the second year of employment, and (ii) twelve months acceleration of vesting of all outstanding options. Effective January 15, 2008, Mr. van Biene resigned. In connection with Mr. van Biene's resignation and in exchange for a full release of claims against us, we have agreed to pay Mr. van Biene twelve months of his current base salary and provide him twelve months of continued coverage under our group health plan. POTENTIAL SEVERANCE PAYMENTS As described above, our employment agreements with Messrs. Forte, van Biene and Schnell provided for severance benefits in the event that the executive's employment is terminated due to executive's death or disability or by the Company without "cause" and, in the case of Mr. Forte, for "good reason." The following table sets forth severance payments and benefits that we would have been obligated to pay to Messrs. Forte, van Biene and Schnell assuming a triggering event had occurred under each of their respective agreements as of December 31, 2007: VALUE OF CONTINUATION ACCELERATION OF HEALTH OF VESTING TOTAL CASH SEVERANCE BONUS VALUE BENEFITS OF EQUITY SEVERANCE NAME PAYMENT ($)(1) ($) ($) AWARDS ($)(2) BENEFITS ($) ------------------------- ------------- ------------- -------------

------------- ------------- Lonnie D. Schnell .... 240,968 -- 11,343 -- 252,311 Stephen P. Forte .... 310,420 -- 12,483 10,000 332,903 Wouter van Biene .... 244,471 -- 11,502 -- 255,973 83 ---------- (1) Includes (i) earned and unpaid base salary through the date of termination, (ii) accrued but unpaid vacation and (iii) cash severance payments based on the executive's salary payable in a lump sum or periodic payments as provided in the executive's employment agreement. (2) Based on the closing price of our common stock on December 31, 2007 of $0.41, as reported by the OTC Bulletin Board. POTENTIAL CHANGE IN CONTROL PAYMENTS As described above, our employment agreements with Messrs. Forte, van Biene and Schnell provided for accelerated vesting of all or a portion of the options held by such executives upon a change in control. The following table sets forth the change in control benefits that we would have been obligated to pay to our named executive officers assuming a change of control had occurred as of December 31, 2007: VALUE OF ACCELERATION OF VESTING OF EQUITY AWARDS ($)(1) --- CHANGE IN CONTROL WITH NAME CHANGE IN CONTROL ONLY (2) ADDITIONAL TRIGGER (3) -- Stephen P. Forte 10,000 10,000 Wouter van Biene - - Lonnie D. Schnell - - ---------- (1) Based on the closing price of our common stock on December 31, 2007 of $0.41, as reported by the OTC Bulletin Board. (2) Upon a change in control, (i) Mr. Forte was entitled to full acceleration of currently outstanding options and (ii) Messrs. van Biene and Schnell are each entitled to accelerated vesting with respect to 50% of the unvested portion of outstanding options. (3) Messrs. van Biene and Schnell are each entitled to full acceleration of vesting of the remaining unvested portion of all outstanding stock options if, within in 12 months following the change in control: (i) he is terminated by the acquirer, (ii) his position is reduced to less than a general manager position or a vice president level position, (iii) his base pay is reduced below his prevailing base pay amount at the time of the change in control or (iv) he is asked to relocate to an office more than 60 miles from his office prior to the change in control. DIRECTOR COMPENSATION The general policy of the Board of Directors is that compensation for independent directors should be a mix of cash and equity-based compensation. We do not pay management directors for Board service in addition to their regular employee compensation. The full Board of Directors has the primary responsibility for reviewing and considering any revisions to director compensation. 84 The following table details the total compensation earned by the company's non-employee directors in 2007. FEES EARNED OR OPTION ALL OTHER TOTAL NAME PAID IN CASH ($) AWARDS ($)(9) COMPENSATION ($) ($) ----------------------- ------------------ ------------------ ------------------ ------------------ Mark Dyne (1) 40,000 3,230 100,500 143,730 Colin Dyne (2) - 5,650 304,000 309,650 Brent Cohen (3) 84,583 1,250 14,417 100,250 Joseph Miller (4) 68,975 600 - 69,575 Raymond Musci (5) 64,375 600 - 64,975 William Sweedler (6) 39,667 300 - 39,967 Susan White (7) 33,417 600 4,833 38,850 Jonathan Burstein (8) - 4,250 290,507 294,757 ----------------------- ------------------ ------------------ ----------------- ------------------ Total 260,667 16,480 784,607 1,061,754 ----------------------- ------------------ ------------------ ----------------- ------------------ ---------- (1) As of December 31, 2007, Mr. Mark Dyne held options to purchase a total of 323,000 shares. The other compensation consists of consulting and per diem fees earned for services rendered. (2) As of December 31, 2007, Mr. Colin Dyne held options to purchase a total of 565,000 shares. The other compensation consists of consulting fees for services rendered. (3) As of December 31, 2007, Mr. Cohen held options to purchase a total of 125,000 shares. The other compensation consists of consulting fees for services rendered. (4) As of December 31, 2007, Mr. Miller held options to purchase a total of 60,000 shares. (5) As of December 31, 2007, Mr. Musci held options to purchase a total of 60,000 shares. (6) As of December 31, 2007, Mr. Sweedler held options to purchase a total of 30,000 shares. (7) As of December 31, 2007, Ms. White held options to purchase a total of 60,000 shares. The other compensation consists of consulting fees for services rendered. Ms. White resigned from the Board of Directors as of October 1, 2007. (8) As of December 31, 2007, Mr. Burstein held options to purchase a total of 425,000 shares. The other compensation consists of consulting fees for services rendered. Mr. Burstein resigned from the Board of Directors as of October 25, 2007. (9) The amounts in this column represent the dollar amounts recognized for financial statement purposes in fiscal 2007 with respect to stock options granted in 2007 as well as prior fiscal years, in accordance with SFAS 123(R). For additional information on the valuation assumptions with respect to option grants, including the options granted in 2007, see Note 9 to the Consolidated Financial Statements in this Annual Report on Form 10-K. These amounts do not reflect the actual value that may be realized by the named executive officers which depends on the value of our shares in the future. Our policy is to pay non-employee directors $1,500 for their personal attendance at any meeting of the Board of Directors, $1,000 for their personal attendance at any committee meeting, and $500 for attendance at any telephonic meeting of the Board of Directors or of a committee of the Board of Directors. We also pay non-employee directors an annual retainer of $20,000 for Board service and an additional retainer of $5,000 for service on each committee. The Chairman of the Board receives an annual retainer of $25,000 for Board service. We also reimburse directors for their reasonable travel expenses incurred in attending board or committee meetings and pay non-employee directors a per diem for board services. We do not have a formal policy with regard to option grants to our Board of Directors, but we generally follow a practice of granting an option for 30,000 shares of stock upon initial appointment or election to the Board of Directors, and thereafter issuing annual option grants to all non-employee members of 30,000 shares. 85 During 2006 and through March 31, 2007 we had a verbal agreement with Mr. Colin Dyne to provide consulting services following his resignation in 2005 as our Chief Executive Officer. We entered into a written agreement with Mr. Dyne effective April 1, 2007 that provides for continued consulting services through November 30, 2008 in exchange for a consulting fee of $25,000 per month. Effective January 1, 2007, we entered into a consulting agreement with Jonathan Burstein, previously a member of the Board of Directors. Under the terms of the consulting agreement, Mr. Burstein provides specified consulting services to us for a term of up to 24 months. As consideration for the services, we pay Mr. Burstein an amount of $225,000 per annum plus an additional $3,333.33 per month for the first 18 months of the term of the agreement. We also agreed to provide Mr. Burstein with medical benefits and an automobile allowance for a period of 18 months. COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION The Compensation Committee of our Board of Directors currently consists of Brent Cohen, Raymond Musci and William Sweedler. No current executive officer of the Company has served as a member of the board of directors or compensation committee of any entity for which a member of our Board of Directors or Compensation Committee has served as an executive officer. ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS EQUITY COMPENSATION PLAN INFORMATION The following table sets forth certain information as of December 31, 2007 regarding equity compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance: NUMBER OF SECURITIES NUMBER OF SECURITIES TO WEIGHTED-AVERAGE REMAINING AVAILABLE BE ISSUED UPON EXERCISE EXERCISE PRICE OF FOR FUTURE ISSUANCE OF OUTSTANDING OPTIONS, OUTSTANDING OPTIONS, UNDER EQUITY WARRANTS AND RIGHTS WARRANTS AND RIGHTS COMPENSATION PLANS ---------------------- -------------------- -------------------- Equity compensation plans approved by security holders..... 3,048,235 $ 1.99 2,600,000 Equity compensation plans not approved by security holders..... 4,788,813 $ 1.48 - ---------------------- -------------------- -------------------- Total........................ 7,837,048 $ 1.67 2,600,000 ====================== ==================== ==================== Options and warrants issued pursuant to equity compensation plans not approved by security holders are summarized as follows: o 172,500 warrants issued for services in 2003, are exercisable at $5.06 per share and expire in May 2008. o 572,818 warrants issued for services in 2003, are exercisable at $4.74 per share and expire in December 2008. o 102,741 warrants issued in conjunction with a private placement transaction in 2004, are exercisable at $3.65 per share and expire in November 2009. o 215,754 warrants issued for services in 2004, are exercisable at $3.65 per share and expire in November 2009. o 2,100,000 warrants issued in conjunction with private placement transaction in 2007, are exercisable at $0.75 per share and expire in June 2012. 86 o 1,625,000 inducement options issued to employees in 2006 are exercisable at a weighted average exercise price of $0.46 per share and expire in January and March of 2016. Each of the above plans provides that the number of shares with respect to which options and warrants may be granted, and the number of shares of common stock subject to an outstanding option or warrant, shall be proportionately adjusted in the event of a subdivision or consolidation of shares or the payment of a stock dividend on common stock. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT The following table presents information regarding the beneficial ownership of our common stock as of April 11, 2008: o each person who is known to us to be the beneficial owner of more than 5% of our outstanding common stock; o each of our directors; o each of our named executive officers; and o all of our directors and executive officers as a group Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission that deem shares to be beneficially owned by any person who has or shares voting or investment power with respect to such shares. Shares of common stock under warrants or options currently exercisable or exercisable within 60 days of the date of this information are deemed outstanding for purposes of computing the percentage ownership of the person holding such warrants or options but are not deemed outstanding for computing the percentage ownership of any other person. As a result, the percentage of outstanding shares of any person as shown in this table does not necessarily reflect the person's actual ownership or voting power with respect to the number of shares of common stock actually outstanding at April 11, 2008. Unless otherwise indicated, the persons named in this table have sole voting and sole investment power with respect to all shares shown as beneficially owned, subject to community property laws where applicable. As of April 11, 2008, we had 20,291,433 shares of common stock issued and outstanding. The address of each person listed is in our care, at 21900 Burbank Boulevard, Suite 270, Woodland Hills, California 91367, unless otherwise set forth below such person's name. NUMBER OF PERCENT NAME OF BENEFICIAL OWNER SHARES OF CLASS -- -------------- ---------- DIRECTORS: Mark Dyne (1).............................. 1,242,001 6.0% Colin Dyne (2)............................. 747,780 3.6% Larry Dyne (3)............................. 547,137 2.6% Lonnie D. Schnell (4)...................... 291,667 1.4% William Sweedler (5)....................... 132,000 * Brent Cohen (6) .... 125,000 * Raymond Musci (6).......................... 60,000 * Joseph M. Miller (6)....................... 60,000 * David A. Hunter............................ - * Directors and executive officers as a group 3,205,585 14.5% (9 persons) (7) .... OTHER 5% HOLDERS: Bluefin Capital, LLC .... 1,750,000 8.6% 105 S. Narcissus Ave., Suite 712 West Palm Beach, FL 33401 87 ---------- * Less than one percent. (1) Includes 323,000 shares of common stock reserved for issuance upon exercise of stock options which are currently exercisable and 83,334 shares of common stock reserved for issuance upon exercise of warrants which are currently exercisable. Includes 176,600 shares held by a limited liability company of which Mr. Dyne is the manager and a member. (2) Includes 565,000 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable. (3) Includes 417,537 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable. Also includes 129,600 shares of common stock held by a family trust which Mr. Larry Dyne may be deemed to beneficially own. (4) Includes 191,667 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable. (5) Includes 30,000 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable. (6) Consists of shares of common stock reserved for issuance upon the exercise of the stock options that are currently exercisable. (7) Includes 1,772,204 shares of common stock reserved for issuance upon exercise of stock options which currently are exercisable and 83,334 shares of common stock reserved for issuance upon exercise of warrants which currently are exercisable. The information as to shares beneficially owned has been individually furnished by the respective directors, named executive officers, and other stockholders of the company, or taken from documents filed with the Securities and Exchange Commission. ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE REVIEW AND APPROVAL OF RELATED PARTY TRANSACTIONS We have adopted a policy that requires Board approval of transactions with related persons as defined by SEC regulations, including any sales or purchase transaction, asset exchange transaction, operating agreement, or advance or receivable transaction that could put our assets or operating performance at risk. All of our directors and executive officers of the Company are required at all times, but not less than annually, to disclose all relationships they have with companies or individuals that have conducted business with, or had an interest in, the Company. Our executive officers monitor our operations giving consideration to the disclosed relationships and refer potential transactions to the Board of Directors for approval. The Board of Directors considers a related party transaction for its potential economic benefit to the Company, to ensure the transaction is "arms length" and in accordance with our policies and that it is properly disclosed in our reports to shareholders. REPORTABLE RELATED PARTY TRANSACTIONS Other than the employment arrangements described elsewhere in this report and the transactions described below, since January 1, 2007, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which we were or will be a party: o in which the amount involved exceeds $120,000; and o in which any director, executive officer, shareholder who beneficially owns 5% or more of our common stock or any member of their immediate family had or will have a direct or indirect material interest. 88 Colin Dyne, a member of our Board, is a significant shareholder in People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. During 2007, we had sales of $241,000 to Versatile Entertainment. At December 31, 2007 accounts receivable of $44,000 were outstanding from Versatile Entertainment. At December 31, 2007, we had an aggregate of $625,454 of unsecured notes, advances and accrued interest receivable due from Colin Dyne. The notes and advances bear interest at 7.5% and are due on demand. We paid consulting fees of $304,000 to Colin Dyne during year ended December 31, 2007 for consulting services provided, and have an agreement with Mr. Dyne for services through November 30, 2008. See the "Director Compensation" section in item 11 of this report for a description of this agreement. At December 31, 2007, we had an aggregate of $85,176 in notes and advances due to Mark Dyne, the Chairman of our Board of Directors or to parties related to or affiliated with Mark Dyne. The notes are payable on demand and accrue interest at rates ranging from 0% to 10% per annum. We paid consulting fees to Diversified Investments, a company owned by Mark Dyne, in the amount of $150,000 during the year ended December 31, 2007. On January 1, 2007 we entered into an agreement with Jonathan Burstein, previously our Executive Vice President of Operations and formerly a member of our Board of Directors, to provide consulting services to the Company through December 31, 2008. We paid Mr. Burstein consulting fees of $290,507 during the year ended December 31, 2007. This agreement was terminated by the Company during the fourth quarter of 2007. DIRECTOR INDEPENDENCE Because our common stock is quoted on the OTC Bulletin Board, we are not subject to the listing requirements of any securities exchange or Nasdaq regarding the independence of our directors. However, our Board of Directors has determined that as of December 31, 2007, a majority of our Board of Directors is comprised of "independent" directors within the meaning of the applicable rules for companies listed on The Nasdaq Stock Market. The Board determined that each of Brent Cohen, Joseph Miller, Raymond Musci, and William Sweedler were independent. The Board has also determined that each of Joseph Miller, Raymond Musci and William Sweedler meet the independence requirements for services on the Audit Committee pursuant to the rules for companies traded on The NASDAQ Stock Market. ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES SERVICES PROVIDED BY THE INDEPENDENT AUDITORS The audit committee of our Board of Directors is responsible for the appointment, compensation, retention and oversight of the work of the independent auditors. Singer Lewak Greenbaum & Goldstein LLP ("SLGG") served as our independent registered public accounting firm for each of the fiscal years ended December 31, 2006 and 2007. AUDIT FEES - The aggregate fees billed by our independent registered accounting firm for professional services rendered for the audit of our annual financial statements and review of our financial statements included in our Forms 10-Q or services that are normally provided in connection with statutory and regulatory filings, were $302,000 for fiscal year 2006 and $350,000 for fiscal year 2007. 89 AUDIT-RELATED FEES - The aggregate fees billed by our independent registered accounting firm for professional services rendered for assurance and related services reasonably related to the performance of the audit or review of our financial statements (other than those reported above) was $66,000 for fiscal year 2006 and $57,300 for fiscal year 2007. TAX FEES - The aggregate fees billed by our independent registered accounting firm for professional services rendered for tax compliance, tax advice and tax planning were $37,000 for fiscal year 2006 and $33,400 for fiscal year 2007. ALL OTHER FEES - The aggregate fees billed by our independent registered accounting firm for services rendered to us other than the services described above under "Audit Fees," "Audit-Related Fees" and "Tax Fees" were $13,000 for fiscal year 2006 and $25,400 for fiscal year 2007. The audit committee approved all of the foregoing services provided by SLGG. POLICY REGARDING PRE-APPROVAL OF SERVICES PROVIDED BY THE INDEPENDENT AUDITORS The audit committee has established a general policy requiring it's pre-approval of all audit services and permissible non-audit services provided by the independent auditors, along with the associated fees for those services. For both types of pre-approval, the audit committee considers whether the provision of a non-audit service is consistent with the SEC's rules on auditor independence, including whether provision of the service (1) would create a mutual or conflicting interest between the independent auditors and the Company, (2) would place the independent auditors in the position of auditing its own work, (3) would result in the independent auditors acting in the role of management or as an employee of the Company, or (4) would place the independent auditors in a position of acting as an advocate for the Company. Additionally, the audit committee considers whether the independent auditors are best positioned and qualified to provide the most effective and efficient service, based on factors such as the independent auditors' familiarity with our business, personnel, systems or risk profile and whether provision of the service by the independent auditors would enhance our ability to manage or control risk or improve audit quality or would otherwise be beneficial to us. 90 PART IV ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (a) List the following documents filed as a part of this report: (1) FINANCIAL STATEMENTS See Index to Financial Statements in Item 8 of this Annual Report on Form 10-K, which is incorporated herein by reference. (2) FINANCIAL STATEMENT SCHEDULES Schedule II - Valuation and Qualifying Accounts Reserves is included beginning on the following page. (3) EXHIBITS See Exhibit Index attached to this Annual Report on Form 10-K, which is incorporated herein by reference. 91 SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES COLUMN A COLUMN B COLUMN C COLUMN D COLUMN E Balance at Balance at Beginning of End of Description Year Additions Deductions Year -------------------------------------- ---------- ---------- ---------- ---------- 2007 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 71,500 $ 135,000 $ 66,000 $ 140,500 Reserve for obsolescence deducted from inventories on the balance sheet .... 1,242,000 148,000 368,000 1,022,000 Valuation reserve deducted from Deferred tax Assets .... 19,225,000 938,000 -- 20,163,000 ----------- ----------- ----------- ----------- $20,538,500 $ 1,221,000 $ 434,000 $21,325,500 =========== ========== =========== =========== 2006 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 1,189,000 $ 198,000 $ 1,315,500 $ 71,500 Reserve for obsolescence deducted from inventories on the balance sheet .... 7,306,000 557,000 6,621,000 1,242,000 Valuation reserve deducted from Deferred tax Assets .... 21,447,000 -- 2,222,000 19,225,000 ---------- ---------- ---------- ---------- $29,942,000 $ 755,000 $10,158,500 $20,538,500 =========== ========== ========== =========== 2005 ---- Allowance for doubtful accounts deducted from accounts receivable in the balance sheet .... $ 6,086,000 $ 4,160,000 $ 9,057,000 $ 1,189,000 Reserve for obsolescence deducted from inventories on the balance sheet .... 6,365,000 2,538,000 1,597,000 7,306,000 Valuation reserve deducted from Deferred tax Assets .... 8,900,000 12,547,000 -- 21,447,000 ----------- ----------- ----------- ----------- $21,351,000 $19,245,000 $10,654,000 $29,942,000 ========== ========== ========== =========== (1) Additions to the allowance for doubtful accounts include provisions for uncollectible accounts. Bad debt expense includes (and additions above exclude) net recoveries of $712,000 for the year ended December 31, 2006, and net direct write-offs of $114,000 and $1,698,000 for the years ended December 31, 2007 and 2005, respectively. Additions to the inventory obsolescence reserve include current year provisions. Additionally, in 2005 there were direct write-offs of inventory of $3.4 million in connection with the restructuring, and in 2007 and 2006 there were direct write-offs of $0.4 million and $0.2 million, respectively. (2) Deductions from the allowance for doubtful accounts includes amounts applied to write-offs, reversals of prior period provisions, and, for the year ended December 31, 2005, deductions include $7,528,000 related to the conversion of a trade account receivable to a note receivable. Deductions from the inventory obsolescence reserve include application of the reserve against obsolete, excess, slow-moving or disposed inventory. 92 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. TALON INTERNATIONAL, INC. /S/LONNIE D. SCHNELL ----------------------------------- By: Lonnie D. Schnell Its: Chief Executive Officer & Chief Financial Officer POWER OF ATTORNEY Each person whose signature appears below constitutes and appoints Lonnie D. Schnell and Mark Dyne, and each of them, as his true and lawful attorneys-in-fact and agents with full power of substitution and resubstitution, for him and his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-K and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the foregoing, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or either of them, or their substitutes, may lawfully do or cause to be done by virtue hereof. SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. SIGNATURE TITLE DATE --------- ----- ---- /s/ Lonnie D. Schnell Chief Executive Officer and Chief April 15, 2008 -------------------- Financial Officer (Principal Lonnie D. Schnell Executive and Financial Officer) /s/ David A. Hunter Vice President Corporate Controller April 15, 2008 -------------------- (Principal Accounting Officer) David A. Hunter /s/ Mark Dyne Chairman of the Board of Directors April 15, 2008 --------------------- Mark Dyne /s/ Colin Dyne Vice Chairman of the Board of April 15, 2008 --------------------- Directors Colin Dyne /s/ Brent Cohen Director April 15, 2008 --------------------- Brent Cohen /s/ Raymond Musci Director April 15, 2008 --------------------- Raymond Musci /s/ Joseph Miller Director April 15, 2008 --------------------- Joseph Miller /s/ William Sweedler Director April 15, 2008 --------------------- William Sweedler 93 EXHIBIT INDEX EXHIBIT NUMBER EXHIBIT DESCRIPTION ------- ------------------- 3.1 Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 3.1.2 Certificate of Designation of Rights, Preferences and Privileges of Series A Preferred Stock. Incorporated by reference to Exhibit A to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. 3.1.3 Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.4 to Annual Report on Form 10-KSB, filed March 28, 2000. 3.1.4 Certificate of Amendment of Certificate of Incorporation of Registrant. Incorporated by reference to Exhibit 3.1.3 to Form 8-K filed on August 4, 2006. 3.1.5 Certificate of Ownership and Merger. Incorporated by reference to Exhibit

3.1 to Form 8-K filed on July 20, 2007. 3.2 Bylaws of Registrant. Incorporated by reference to Exhibit 3.2 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 4.1 Specimen Stock Certificate of Common Stock of Registrant. Incorporated by reference to Exhibit 4.1to Form SB-2 filed on October 21, 1997, and the amendments thereto. 4.2 Rights Agreement, dated as of November 4, 1998, between Registrant and American Stock Transfer and Trust Company as Rights Agent. Incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. 4.3 Form of Rights Certificate. Incorporated by reference to Exhibit B to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. 10.1 Form of Indemnification Agreement. Incorporated by reference to Exhibit 10.1to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.2 Promissory Note, dated September 30, 1996, provided by Tag-It, Inc. to Harold Dyne. Incorporated by reference to Exhibit 10.21 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.3 Promissory Note, dated June 30, 1991, provided by Tag-It, Inc. to Harold Dyne. Incorporated by reference to Exhibit 10.23 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.5 Promissory Note, dated February 29, 1996, provided by A.G.S. Stationary, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.25 of Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.6 Promissory Note, dated January 19, 1995, provided by Pacific Trim & Belt, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.26 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 94 EXHIBIT NUMBER EXHIBIT DESCRIPTION ------- ------------------- 10.7(2) Amended and Restated 1997 Stock Incentive Plan. Incorporated by reference to Exhibit 10.7 to Form 10-Q filed on November 13, 2006. 10.8(2) Form of Non-statutory Stock Option Agreement. Incorporated by reference to Exhibit 10.30 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.9 Promissory Note, dated August 31, 1997, provided by Harold Dyne to Pacific Trim & Belt, Inc. Incorporated by reference to Exhibit 10.32 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.10 Promissory Note, dated October 15, 1997, provided by Harold Dyne to Pacific Trim & Belt, Inc. Incorporated by reference to Exhibit 10.34 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.11 Promissory Note, dated October 15, 1997, provided by A.G.S. Stationary Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.48 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.12 Promissory Note, dated November 4, 1997, provided by Pacific Trim & Belt, Inc. to Monto Holdings Pty. Ltd. Incorporated by reference to Exhibit 10.49 to Form SB-2 filed on October 21, 1997, and the amendments thereto. 10.13 Form of Investor Rights Agreements dated December 28, 2001. Incorporated by reference to Exhibit 99.4 to Form 8-K filed on January 23, 2002. 10.14(1) Intellectual Property Rights Agreement, dated April 2, 2002, between the Company and Pro-Fit Holdings, Ltd. Incorporated by reference to Exhibit 10.69 to Form 10-K/A filed on October 1, 2003. 10.15 Common Stock Purchase Warrant dated December 18, 2003 between the Company and Sanders Morris Harris Inc. Incorporated by reference to Exhibit 99.4 to Form 8-K filed on December 22, 2003. 10.16 Form of Common Stock Purchase Warrant, dated as of November 9, 2004. Incorporated by reference to Exhibit 10.3 to Form S-3 filed on December 9, 2004. 10.17 Common Stock Purchase Warrant dated as of November 9, 2004, issued by the Registrant in favor of Sanders Morris Harris Inc. Incorporated by reference to Exhibit 10.7 to Form S-3 filed on December 9, 2004. 10.18(2) Employment offer letter dated March 16, 2006 between the Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.3 to Form 10-Q filed on May 22, 2006. 10.18.1(2) Amendment, dated May 25, 2007, to employment offer letter dated March 16, 2006 between the Registrant and Lonnie D. Schnell. Incorporated by reference to Exhibit 10.31.2 to Form 10-Q filed on August 14, 2007. 10.19(2) Consulting Agreement dated January 1, 2007 between the Registrant and Jonathan Burstein. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on January 3, 2007. 10.19(2) Consulting Agreement effective April 1, 2007 between the Registrant and Colin Dyne. Incorporated by reference to Exhibit 10.34 to Form 10-Q filed on May 15, 2007. 95 EXHIBIT NUMBER EXHIBIT DESCRIPTION ------- ------------------- 10.20(2) 2007 Stock Plan. 10.21 Revolving Credit and Tern Loan Agreement dated June 27, 2007, by and between Tag-It Pacific, Inc. and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.35 to Form 10-Q filed on August 14, 2007. 10.21.1 Amendment No. 1 to Loan Agreement dated July 30, 2007, by and between the Registrant and Bluefin Capital, LLC. 10.21.2 Amendment No. 2 to Loan Agreement dated November 19, 2007, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.35.2 to Form 8-K filed on November 26, 2007. 10.22 Guaranty Agreement, dated June 27, 2007, by Talon International, Inc., Tag-It, Inc., A.G.S. Stationary, Inc., Tag-It Pacific Limited, Tag-It Pacific (HK) Ltd., Tagit de Mexico, S.A. de C. V., Talon Zipper (Shenzhen) Company, Ltd., and Talon International, Pvt. Ltd. in favor of Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.36 to Form 10-Q filed on August 14, 2007. 10.23 Collateral Agreement, dated June 27, 2007, by and among Tag-It Pacific, Inc., Talon International, Inc., Tag-It, Inc., A.G.S. Stationary, Inc., Tag-It Pacific Limited, Tag-It Pacific (HK) Ltd., Tagit de Mexico, S.A. de C. V., Talon Zipper (Shenzhen) Company, Ltd., and Talon International, Pvt. Ltd. in favor of Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.37 to Form 10-Q filed on August 14, 2007. 10.24 Registration Rights Agreement, dated June 27, 2007, by Talon International, Inc., for the benefit of holders. Incorporated by reference to Exhibit 4.10 to Registration Statement on Form S-3 filed on August 10, 2007. 10.25 Form of Warrant issued to Bluefin Capital, LLC. Incorporated by reference to Exhibit 4.10 to Registration Statement on Form S-3 filed on August 10, 2007. 10.26 Promissory Note, dated June 27, 2007, executed by Colin Dyne in favor of Tag-It Pacific, Inc. Incorporated by reference to Exhibit 10.40 to Form 10-Q filed on August 14, 2007. 14.1 Code of Ethics. Incorporated by reference to Exhibit 14.1 to Form 10-K filed on March 30, 2004. 21.1 Subsidiaries. 23.1 Consent of Singer Lewak Greenbaum & Goldstein LLP. 24.1 Power of Attorney (included on signature page). 31.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended. 32.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended. ---------- (1) Certain portions of this agreement have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for an order granting confidential treatment pursuant to Rule 406 of the General Rules and Regulations under the Securities Act of 1933, as amended. (2) Indicates a management contract or compensatory plan. 96