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TALON INTERNATIONAL, INC.
Form 10-K
April 09, 2009

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

FORM 10-K

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008

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

Commission file number 1-13669

TALON INTERNATIONAL, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation or Organization)

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

21900 BURBANK BLVD., SUITE 270
WOODLAND HILLS, CALIFORNIA 91367
(Address of Principal Executive Offices) (Zip Code)

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

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

NONE

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

COMMON STOCK, \$.001 PAR VALUE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registration is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for past 90 days.

Yes No

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

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

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

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

At June 30, 2008, the aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant was \$4,261,204.

At April 9, 2009 the issuer had 20,291,433 shares of Common Stock, \$.001 par value, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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FORWARD LOOKING STATEMENTS

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

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PART I

ITEM 1. BUSINESS

GENERAL

Talon International, Inc. specializes in the manufacturing and distribution of a full range of apparel accessories including zippers and trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We manufacture and distribute zippers under our TALON(R) brand name to manufacturers for apparel brands and retailers such as Abercrombie & Fitch, Wal-Mart, Kohl's, The Gap, Juicy Couture and JC Penney, among others. We also provide full service outsourced trim design, sourcing and management services and supply specified trim items for manufacturers of fashion apparel such as Abercrombie & Fitch, Victoria's Secret, American Eagle, Motherhood, Express, Polo Ralph Lauren and others. Under our TEKFIT(R) brand, we develop and sell apparel components that utilize a patented technology, including a stretch waistband.

We were incorporated in the State of Delaware in 1997. We were formed to serve as the parent holding company of Tag-It, Inc., a California corporation, Tag-It Printing & Packaging Ltd., which changed its name in 1999 to Tag-It Pacific (HK) LTD, a BVI corporation, Tagit de Mexico, S.A. de C.V., A.G.S. Stationery, Inc., a California corporation and Pacific Trim & Belt, Inc., a California corporation. All of these companies were consolidated under a parent limited liability company in October 1997. These companies became our wholly owned subsidiaries immediately prior to the effective date of our initial public offering in January 1998. In 2000, we formed two wholly owned subsidiaries of Tag-It Pacific, Inc: Tag-It Pacific Limited, a Hong Kong corporation and Talon International, Inc., a Delaware corporation. During 2006 we formed two wholly owned subsidiaries of Talon International, Inc. (formerly Tag-It Pacific, Inc.): Talon Zipper (Shenzhen) Company Ltd. in China and Talon International Pvt. Ltd., in India. On July 20, 2007 we changed our corporate name from Tag-It Pacific, Inc. to Talon International, Inc. Our web site is www.talonzippers.com. Our web site address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on our website is not and should not be considered part of this report and is not incorporated by reference in this document.

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BUSINESS SUMMARY

We operate our business within three product groups, Talon, Trim and Tekfit. In our Talon group, we design, engineer, test and distribute zippers under our TALON trademark and trade names to apparel brands and manufacturers. TALON enjoys brand recognition in the apparel industry worldwide. TALON is a 100-year-old brand, which is well known for quality and product innovation and was the original pioneer of the formed wire metal zipper for the jeans industry and is a specified zipper brand for manufacturers in the sportswear and outerwear markets worldwide. We provide a line of high quality zippers, including a specialty zipper for kids clothing, for distribution to apparel manufacturers in Asia, India, Indonesia, Bangladesh, Mexico and Central America and have sales and marketing teams in most of these areas. We have developed, joint manufacturing arrangements in various geographical international local markets to manufacture, finish and distribute zippers under the TALON brand name. Our manufacturing partners operate to our specifications and under our

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quality requirements, compliance controls and our direct manufacturing and quality assurance supervision, producing finished zippers for our customers in their local markets. This operating model allows us to significantly improve the speed at which we serve the market and to expand the geographic footprint of our TALON products. The Talon zipper is promoted both within our trim packages, as well as a stand-alone product line.

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

If our customer is creating a new pair of cargo pants for their fall collection, our Trim products group will collaborate with them on their design vision, then present examples of their vision in graphic form for all apparel accessory components. We will design the buttons, snaps, hang tags, labels, zippers, zipper pullers and other items. Once our customer selects the designs they like, our sourcing and production teams coordinate with our proprietary database of manufacturers worldwide to ensure the best manufacturing solution for the items being produced. The proper manufacturing and sourcing solution is a critical part of our service. Knowing the best facility or supplier to ensure timely production, the proper paper finishes, distressing or other types of material needs or manufacturing techniques to be used is critical. Because we perform this function for many different global projects and apparel brands, we have a depth and breadth of knowledge in the manufacturing and sourcing that our customers cannot achieve, and therefore offer a significant value to our customers. In addition, because we are consistently innovating new items, manufacturing techniques and finishes, we bring many new, fresh and unique ideas to our customers. Once we identify the appropriate supply source, we create production samples of all of our designs and products and review the samples with our customers so they can make a final decision while looking at the actual items that will be used on the garments. When the customer selects the appropriate items, we are identified as the sole-source trim supplier for the project, and our customer's factories are then required to purchase the trim products from us. Throughout the garment manufacturing process, we consistently monitor the timing and accuracy of the production items to ensure the production items exactly match all samples when delivered to our customer's apparel factories.

We also serve as a specified supplier in our zipper and trim products for a variety of major retail brand and private-label oriented companies. A specified supplier is a supplier that has been approved for its quality and service by a major retail brand or private-label company. Apparel contractors manufacturing for the retail brand or private-label company must purchase their zipper and trim requirements from a supplier that has been specified. We seek to expand our services as a supplier of select items for such customers, to being a preferred or single-source provider of the entire brand customer's authorized trim and zipper requirements. Our ability to offer a full range of trim and zipper products is attractive to brand name and private-label oriented customers because it enables the customer to address their quality and supply needs for

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all of their trim requirements from a single source, avoiding the time and expense necessary to monitor quality and supply from multiple vendors and manufacturer sources. Becoming a specified supplier to brand customers gives us an advantage to become the preferred or sole vendor of trim and zipper items for all apparel manufacturers contracted for production for that brand name.

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

PRODUCTS

TALON ZIPPERS - We offer a full line of metal and synthetic zippers bearing the TALON brand name. TALON zippers are used primarily by manufacturers in the apparel industry and are distributed through our distribution facilities in the United States, India, Indonesia, Bangladesh and China and through our agents, distributors and affiliates in other international markets.

We plan to expand our distribution of TALON zippers through the establishment of a network of TALON owned sales, distribution and manufacturing locations, distribution relationships and joint ventures. The network of these distributors and manufacturing joint ventures, in combination with TALON owned and affiliated facilities under the TALON brand, is expected to improve our time-to-market by eliminating the typical setup and build-out phase for new manufacturing capacity throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets. The branded apparel zipper market is dominated by one company and we are positioning TALON to be a viable global alternative to this competitor and capture an increased market share position. We plan to leverage the brand awareness of the TALON name by branding other products in our line with the TALON name.

TRIM - We consider our high level of customer service as a fully integrated single-source supplier essential to our success. We combine our high level of customer service within our TRIM solutions with a history of design and manufacturing expertise to offer our customers a complete trim solution product. We believe this full-service product gives us a competitive edge over companies that only offer selected trim components because our full service solutions saves our customers substantial time in ordering, designing, sampling and managing trim orders from several different suppliers. Our proprietary tracking and order management systems allow us to seamlessly supply trim solutions and products to apparel brands, retailers and manufacturers around the world.

We produce customized woven, leather, synthetic, embroidered and novelty labels and tapes, which can be printed on or woven into a wide range of fabrics and other materials using various types of high-speed equipment. As an additional service, we may provide our customers the machinery used to attach the buttons, rivets and snaps we distribute.

TEKFIT - We distribute a proprietary stretch waistband under our Exclusive License and Intellectual Property Rights agreement with Pro-Fit Holdings, Limited. The agreement gives us the exclusive rights to sell or sublicense stretch waistbands manufactured under the patented technology developed by Pro-Fit for garments manufactured anywhere in the world for sale in the U.S. market and for all U.S. brands for the life of the patent. We offer apparel manufacturers advanced, patented fabric technologies to utilize in their garments under the TEKFIT name. This technology allows fabrics to be altered

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through the addition of stretch characteristics resulting in greatly improved fit and comfort. This technology allows pant manufacturers to build-in a stretch factor into standard waistbands that does not alter the appearance of the garment, but will allow the waist to stretch out and back by as much as two waist sizes. Previously, we supplied Levi Strauss & Co. with TEKFIT waistbands for their Dockers(R) programs, under an exclusive supply agreement. In October 2006 our exclusive contract with this brand expired. With the expiration of this contract we now have broader access to other customers, and we intend to actively expand this product offering to other brands.

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Our efforts to expand this product offering to other customers have been limited by a licensing dispute. As described more fully in Item 3 "Legal Proceedings" we are presently in litigation with Pro-Fit related to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured under Pro-Fit's patented technology. The revenues we derive from the sale of products incorporating the stretch waistband technology represented approximately 0.4% of our consolidated revenue for the year ended December 31, 2008, 2% of our consolidated revenue for the year ended December 31, 2007 and 19% for the year ended December 31, 2006. We have been successful in securing new customers, but these new customers and programs are substantially smaller in scale.

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

| | Year Ended December 31, | | |
|----------------------------|-------------------------|-------|-------|
| | 2008 | 2007 | 2006 |
| Product Group Net Revenue: | | | |
| Talon zipper | 59.0% | 52.2% | 34.8% |
| Trim | 40.6% | 46.1% | 46.1% |
| Tekfit | 0.4% | 1.7% | 19.1% |

DESIGN AND DEVELOPMENT

Our in-house creative team produces products with innovative technology and designs that we believe distinguish our products from those of our competitors. We support our skills and expertise in material procurement and product-manufacturing coordination with product technology and designs intended to meet fashion demands, as well as functional and cost parameters. In 2006, we introduced the Talon KidZip which is a specialty zipper for children's apparel engineered to surpass industry established strength and safety tests, while maintaining the fashion image and requirements of today's apparel demands.

Many specialty design companies with which we compete have limited engineering, sourcing or manufacturing experience. These companies create products or designs that often cannot be implemented due to difficulties in the manufacturing process, the expenses of required materials, or a lack of functionality in the resulting product. We design products to function within the limitations imposed by the applicable manufacturing framework. Using our manufacturing and sourcing experience, we ensure delivery of quality products and we minimize the time-consuming delays that often arise in coordinating the efforts of independent design houses and manufacturing facilities. By supporting our material procurement and product manufacturing services with design services, we believe that we reduce development and production costs and deliver

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products to our customers sooner than many of our competitors. Our development costs are low, most of which are borne by our customers. Our design teams are based out of our California and Hong Kong facilities.

CUSTOMERS

We have more than 800 active customers. Our customers include the designated suppliers of well-known apparel manufacturers, such as Abercrombie & Fitch, Tom Tailor, Victoria Secret, Polo Ralph Lauren, American Eagle and Juicy Couture, among others. Our customers also include contractors for specialty retailers such as Express and mass merchant retailers such as Wal-Mart, Kohl's and Target.

For the years ended December 31, 2008, 2007 and 2006, our three largest customers represented approximately 8%, 9% and 18%, respectively, 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.

The results of our operations will depend to an extent upon the commercial success of these customers. If these customers fail to purchase our products at anticipated levels, or the relationship terminates, it may have an adverse affect on our results of operations. If the financial condition of these

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customers were to deteriorate, resulting in an impairment of their ability to purchase inventories or repay receivables, it may also have an adverse affect on our results of operations. The financial position and operations of these customers are monitored on an ongoing basis. United States export sales are not a significant part of our business. Backlogs are not considered material in the industries in which we compete.

SALES AND MARKETING

We sell our principal products through our own sales force based in Los Angeles, California, various other cities in the United States, Hong Kong, China, India, Indonesia, Taiwan and the Dominican Republic. We also employ customer service representatives who are assigned to key customers and provide in-house customer service support. Our executives have developed relationships with our major customers at senior levels. These executives actively participate in marketing and sales functions and the development of our overall marketing and sales strategies. When we become the outsourcing vendor for a customer's packaging or trim requirements, we position ourselves as if we are an in-house department of the customer's trim procurement operation.

SOURCING AND ASSEMBLY

We have developed expertise in identifying high quality materials, competitive prices and approved vendors for particular products and materials. This expertise enables us to produce a broad range of packaging and trim products at various price points. The majority of products that we procure and distribute are purchased on a finished good basis. Raw materials, including paper products and metals used to manufacture zippers, used in the assembly of our Trim products are available from numerous sources and are in adequate supply. We purchase products from several qualified material suppliers.

We create most product artwork and any necessary dies and molds used to design and manufacture our products. All other products that we design and sell are produced by third party vendors or under our direct supervision or through

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joint manufacturing arrangements. We are confident in our ability to secure high quality manufacturing sources. We intend to continue to outsource production to qualified vendors, particularly with respect to manufacturing activities that require substantial investment in capital equipment.

Principally through our Hong Kong facility, we distribute TALON zippers, trim items and apparel packaging and coordinate the manufacture and distribution of the full range of our products. Our Hong Kong facility supplies several significant trim programs, services customers located in Asia and the Pacific Rim and sources products for our Los Angeles based operations.

INTELLECTUAL PROPERTY RIGHTS AND LICENSES

We have trademarks as well as copyrights, software copyrights and trade names for which we rely on common law protection, including the TALON trademark. Several of our other trademarks are the subject of applications for federal trademark protection through registration with the United States Patent and Trademark Office, including "Talon", "Tag-It", "Managed Trim Solution" and "Tekfit". We also rely on our Exclusive License and Intellectual Property Rights agreement with Pro-Fit to sell our TEKFIT Stretch waistbands. The agreement gives us the exclusive rights to sell or sublicense stretch waistbands manufactured under the patented technology developed by Pro-Fit for garments manufactured anywhere in the world for the U.S. market and for all U.S. brands, for an indefinite term that extends for the duration of the patent and trade secrets licensed under the agreement. We are presently in litigation with Pro-Fit relating to our rights under the agreement, as described more fully elsewhere in this report.

SEASONALITY

We typically experience seasonal fluctuations in sales volume. These seasonal fluctuations result in sales volume decreases in the first and fourth quarters of each year due to the seasonal fluctuations experienced by the majority of our customers. The apparel industry typically experiences higher sales volume in the second quarter in preparation for back-to-school purchases and the third quarter in preparation for year-end holiday purchases.

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INVENTORIES

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

COMPETITION

We compete in highly competitive and fragmented industries that include numerous local and regional companies that provide some or all of the products

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we offer. We also compete with United States and international design companies, distributors and manufacturers of tags, trim, packaging products and zippers. Some of our competitors, including YKK, Universal Button, Inc. and Avery Dennison Corporation have greater name recognition, longer operating histories and greater financial and other resources.

Because of our integrated materials procurement and assembly capabilities and our full-service trim solutions, we believe that we are able to effectively compete for our customers' business, particularly where our customers require coordination of separately sourced production functions. We believe that to successfully compete in our industry we must offer superior product pricing, quality, customer service, design capabilities, delivery lead times and complete supply-chain management. We also believe the TALON brand name and the quality of our TALON brand zippers will allow us to gain market share in the zipper industry. The unique stretch quality of our TEKFIT waistbands will also allow us to compete effectively in the market for waistband components.

SEGMENT INFORMATION

We operate primarily in one industry segment, the distribution of a full range of apparel zipper and trim products to manufacturers of fashion apparel, specialty retailers and mass merchandisers.

FINANCIAL INFORMATION ABOUT GEOGRAPHIC AREAS

We sell the majority of our products for use by U.S. based brands, retailers and manufacturers. The majority of these customers produce their products or outsource the production of their products in manufacturing facilities located outside of the U.S., primarily in Asia, Mexico, the Dominican Republic and Central America.

A summary of our domestic and international net sales and long-lived assets is set forth in Item 8 of this Annual Report on Form 10-K, Note 1 and Note 15 to the consolidated financial statements.

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

EMPLOYEES

As of December 31, 2008, we had approximately 167 full-time employees including 29 in the United States, 61 employees in Hong Kong, 72 employees in China, 1 in India, 3 in the Dominican Republic and 1 in Taiwan. Our labor forces are non-union. We believe that we have satisfactory employee and labor relations.

CORPORATE GOVERNANCE AND INFORMATION RELATED TO SEC FILINGS

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed with, or furnished to, the Securities and Exchange Commission ("SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of

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charge through our web site, www.talonzipper.com (in the "Investor" section, as soon as reasonably practical after electronic filing with or furnishing of such material to the SEC). We make available at the Web site our (i) shareholder communications policies, (ii) Code of Ethical Conduct, (iii) the charters of the Audit and Nominating Committees of our Board of Directors and (iv) Employee Complaint Procedures for Accounting and Auditing Matters. These materials are also available free of charge in print to stockholders who request them by writing to: Investor Relations, Talon International, Inc., 21900 Burbank Boulevard, Suite 270, Woodland Hills, CA 91367. Our web site address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on our web site is not and should not be considered part of this report and is not incorporated by reference in this document.

ITEM 1A. RISK FACTORS

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

WE MAY NOT BE ABLE TO SATISFY THE FINANCIAL COVENANTS IN OUR DEBT AGREEMENTS AT AND IF WE CANNOT OUR LENDER COULD DECLARE THE DEBT OBLIGATIONS IN DEFAULT, WHICH WOULD HAVE A MATERIAL ADVERSE EFFECT ON OUR LIQUIDITY, BUSINESS AND OPERATIONS

Our revolving credit and term loan agreement requires certain covenants, including a minimum level of EBITDA beginning with quarterly periods ending June 30, 2008, as discussed in Note 9 to the consolidated financial statements. We failed to satisfy the minimum EBITDA requirement for the quarter ending December 31, 2008 and do not expect to meet the minimum EBITDA requirement for the quarter ending March 31, 2009. Accordingly we have paid our lender a fee to waive these requirements for these quarters. If we fail to satisfy the covenant in three consecutive quarters, the credit agreement will be in default and can be declared immediately due and payable by the lender. In anticipation of us not being able to meet the required covenants due to various reasons, we either negotiate for changes in the relative covenants or an advance waiver or would have to reclassify the relevant debt as current. However, our expectations of future operating results and continued compliance with other debt covenants cannot be assured and our lender's actions are not controllable by us. If we are in default under the loan agreement, all amounts due under the loan agreement can be declared immediately due and payable and, unless we are able to secure alternative financing to repay the lender in full, the lender would have the right to exercise its remedies including enforcement of its lien on substantially all of our assets. Further, if the debt is placed in default, we would be required to reduce our expenses, including curtailing operations and to raise capital through the sale of assets, issuance of equity or otherwise, any of which could have a material adverse effect on our financial condition and results of operations and affect our ability to operate as a going concern. See Note 2 to the consolidated financial statements regarding going concern and Note 19 to the consolidated financial statements for subsequent event regarding waiver of current covenant requirements and additional funding by our lender.

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THE RECENT U.S. AND GLOBAL FINANCIAL AND ECONOMIC CRISIS COULD NEGATIVELY AFFECT OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The recent financial crisis affecting the global banking system and

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financial markets and the going concern threats to financial institutions have resulted in a tightening in the credit markets; a low level of liquidity in many financial markets; and extreme volatility in credit, fixed income, and equity markets. Certain apparel manufacturers and retailers, including some of our customers may experience financial difficulties that increase the risk of extending credit to such customers. Customers adversely affected by economic conditions have also attempted to improve their own operating efficiencies by concentrating their purchasing power among a narrowing group of suppliers. There can be no assurance that we will remain a preferred supplier to our existing customers. A decrease in business from or loss of a major customer could have a material adverse effect on our results of operations and financial condition.

In addition, our performance is subject to worldwide economic conditions and their impact on levels of consumer spending that affect not only the ultimate consumer, but also retailers, which constitute many of our largest customers. Consumer spending recently has deteriorated significantly and may remain depressed, or be subject to further deterioration for the foreseeable future. The worldwide apparel industry is heavily influenced by general economic cycles. Purchases of fashion apparel and accessories tend to decline in periods of recession or uncertainty regarding future economic prospects, as disposable income declines. Many factors affect the level of consumer spending in the apparel industries, including, among others: prevailing economic conditions, levels of employment, salaries and wage rates, energy costs, interest rates, the availability of consumer credit, taxation and consumer confidence in future economic conditions. During periods of recession or economic uncertainty, we may not be able to maintain or increase our sales to existing customers, make sales to new customers, or maintain our earnings from operations as a percentage of net sales. As a result, our operating results may be adversely and materially affected by sustained or further downward trends in the United States or global economy.

THE CURRENT GLOBAL CREDIT CRISIS HAS INCREASED OUR CREDIT RISKS WITH VENDORS AND CUSTOMERS.

We extend credit to some vendors by supplying them products. If any of these vendors are unable to honor their commitments to us, due to bankruptcy, cessation of operations or otherwise, we will likely experience losses on the products we provided and lose profit margins on the unshipped orders. Most of our customers are extended credit terms which are approved by us internally. While we have attempted to cover as much of our credit risks as possible, not all of our risks can be fully hedged due to the current credit crisis. Such exposure may translate into losses should there be any adverse changes to the financial condition of certain customers.

WE MAY NEED TO RAISE ADDITIONAL CAPITAL OR REFINANCE OUR EXISTING DEBT STRUCTURE TO MEET OUR CURRENT AND LONG TERM NEEDS.

We have historically satisfied our working capital requirements primarily through cash flows generated from operations. As we continue to expand globally in response to the industry trend to outsource apparel manufacturing to offshore locations, our foreign customers, some of which are backed by U.S. brands and retailers, represent substantially all of our customers. Our revolving credit facility provides limited financing secured by our accounts receivable, and our current borrowing capability may not provide the level of financing we need to continue in or to expand into additional foreign markets. We are continuing to evaluate non-traditional financing alternatives and equity transactions to provide capital needed to fund our expansion and operations.

If we experience greater than anticipated reductions in sales, we may need to raise additional capital, or further reduce the scope of our business in order to fully satisfy our future short-term liquidity requirements. If we cannot raise additional capital or reduce the scope of our business in response

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to a substantial decline in sales, we may default on our credit agreement.

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The extent of our future long-term capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of future acquisitions, our borrowing base availability limitations related to eligible accounts receivable and inventories and our expansion into foreign markets. Our need for additional long-term financing includes the integration and expansion of our operations to exploit our rights under our Talon trade name, the expansion of our operations in the Asian, Central American and Caribbean markets and the further development of our waistband technology. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise additional debt or equity financing in order to provide for our operations. We are continually evaluating various financing strategies to be used to expand our business and fund future growth or acquisitions. There can be no assurance that additional debt or equity financing will be available on acceptable terms or at all. If we are unable to secure additional financing, we may not be able to execute our plans for expansion, including expansion into foreign markets to promote our Talon brand trade name, and we may need to implement additional cost savings initiatives.

OUR GROWTH AND OPERATING RESULTS COULD BE MATERIALLY, ADVERSELY AFFECTED IF WE ARE UNSUCCESSFUL IN RESOLVING A DISPUTE THAT NOW EXISTS REGARDING OUR RIGHTS UNDER OUR EXCLUSIVE LICENSE AND INTELLECTUAL PROPERTY AGREEMENT WITH PRO-FIT.

Pursuant to our agreement with Pro-Fit Holdings, Limited, we have exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. We are in litigation with Pro-Fit regarding our rights. See Item 3, "Legal Proceedings" for discussion of this litigation. In the past, we had derived a significant amount of revenues from the sale of products incorporating the stretch waistband technology. Our business, future results of operations and financial condition could be materially adversely affected if we are unable to reach a settlement in a manner acceptable to us and ensuing litigation 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.

IF WE LOSE OUR LARGER CUSTOMERS OR THEY FAIL TO PURCHASE AT ANTICIPATED LEVELS, OUR SALES AND OPERATING RESULTS WILL BE ADVERSELY AFFECTED.

Our results of operations will depend to a significant extent upon the commercial success of our larger customers. If these customers fail to purchase our products at anticipated levels, or our relationship with these customers terminates, it may have an adverse affect on our results because:

- o We will lose a primary source of revenue if these customers choose not to purchase our products or services;
- o We may not be able to reduce fixed costs incurred in developing the relationship with these customers in a timely manner;
- o We may not be able to recoup setup and inventory costs;
- o We may be left holding inventory that cannot be sold to other customers; and

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- o We may not be able to collect our receivables from them.

IF CUSTOMERS DEFAULT ON INVENTORY PURCHASE COMMITMENTS WITH US, WE WILL BE LEFT HOLDING NON-SALABLE INVENTORY.

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

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BECAUSE WE DEPEND ON A LIMITED NUMBER OF SUPPLIERS, WE MAY NOT BE ABLE TO ALWAYS OBTAIN MATERIALS WHEN WE NEED THEM AND WE MAY LOSE SALES AND CUSTOMERS.

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

OUR PRODUCTS MAY NOT COMPLY WITH VARIOUS INDUSTRY AND GOVERNMENTAL REGULATIONS AND OUR CUSTOMERS MAY INCUR LOSSES IN THEIR PRODUCTS OR OPERATIONS AS A CONSEQUENCE OF OUR NON-COMPLIANCE.

Our products are produced under strict supervision and controls to ensure that all materials and manufacturing processes comply with the industry and governmental regulations governing the markets in which these products are sold. However, if these controls fail to detect or prevent non-compliant materials from entering the manufacturing process, our products could cause damages to our customer's products or processes and could also result in fines being incurred. The possible damages and fines could significantly exceed the value of our products and these risks may not be covered by our insurance policies.

WE OPERATE IN AN INDUSTRY THAT IS SUBJECT TO SIGNIFICANT FLUCTUATIONS IN OPERATING RESULTS THAT MAY RESULT IN UNEXPECTED REDUCTIONS IN REVENUE AND STOCK PRICE VOLATILITY.

We operate in an industry that is subject to significant fluctuations in operating results from quarter to quarter, which may lead to unexpected reductions in revenues and stock price volatility. Factors that may influence our quarterly operating results include:

- o The volume and timing of customer orders received during the quarter;
- o The timing and magnitude of customers' marketing campaigns;
- o The loss or addition of a major customer;
- o The availability and pricing of materials for our products;
- o The increased expenses incurred in connection with the introduction of new products;

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- o Currency fluctuations;
- o Delays caused by third parties; and
- o Changes in our product mix or in the relative contribution to sales of our subsidiaries.

Due to these factors, it is possible that in some quarters our operating results may be below our stockholders' expectations and those of public market analysts. If this occurs, the price of our common stock could be adversely affected. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against such a company. In October 2005, a securities class action lawsuit was filed against us. See Item 3, "Legal Proceedings" for a detailed description of this lawsuit.

THE OUTCOME OF LITIGATION IN WHICH WE HAVE BEEN NAMED AS A DEFENDANT IS UNPREDICTABLE AND AN ADVERSE DECISION IN ANY SUCH MATTER COULD HAVE A MATERIAL ADVERSE AFFECT ON OUR FINANCIAL POSITION AND RESULTS OF OPERATIONS.

We are defendants in a number of litigation matters. These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made in each and all of the litigation matters to which we have been named a party and intend to contest each lawsuit vigorously, no assurances can

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be given that the results of these matters will be favorable to us. An adverse resolution of any of these lawsuits could have a material adverse affect on our financial position and results of operations.

We maintain product liability and director and officer insurance that we regard as reasonably adequate to protect us from potential claims; however we cannot assure you that it will be adequate to cover any losses. Further, the costs of insurance have increased dramatically in recent years, and the availability of coverage has decreased. As a result, we cannot assure you that we will be able to maintain our current levels of insurance at a reasonable cost, or at all.

OUR CUSTOMERS HAVE CYCLICAL BUYING PATTERNS WHICH MAY CAUSE US TO HAVE PERIODS OF LOW SALES VOLUME.

Most of our customers are in the apparel industry. The apparel industry historically has been subject to substantial cyclical variations. Our business has experienced, and we expect our business to continue to experience, significant cyclical fluctuations due, in part, to customer buying patterns, which may result in periods of low sales usually in the first and fourth quarters of our financial year.

OUR BUSINESS MODEL IS DEPENDENT ON INTEGRATION OF INFORMATION SYSTEMS ON A GLOBAL BASIS AND, TO THE EXTENT THAT WE FAIL TO MAINTAIN AND SUPPORT OUR INFORMATION SYSTEMS, IT CAN RESULT IN LOST REVENUES.

We must consolidate and centralize the management of our subsidiaries and significantly expand and improve our financial and operating controls. Additionally, we must effectively integrate the information systems of our worldwide operations with the information systems of our principal offices in

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California. Our failure to do so could result in lost revenues, delay financial reporting or have adverse effects on the information reported.

THE LOSS OF KEY MANAGEMENT AND SALES PERSONNEL COULD ADVERSELY AFFECT OUR BUSINESS, INCLUDING OUR ABILITY TO OBTAIN AND SECURE ACCOUNTS AND GENERATE SALES.

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

IF WE EXPERIENCE DISRUPTIONS AT ANY OF OUR FOREIGN FACILITIES, WE WILL NOT BE ABLE TO MEET OUR OBLIGATIONS AND MAY LOSE SALES AND CUSTOMERS.

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

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

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INTERNET-BASED SYSTEMS THAT WE RELY UPON FOR OUR ORDER TRACKING AND MANAGEMENT SYSTEMS MAY EXPERIENCE DISRUPTIONS AND AS A RESULT WE MAY LOSE REVENUES AND CUSTOMERS.

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

THERE ARE MANY COMPANIES THAT OFFER SOME OR ALL OF THE PRODUCTS AND SERVICES WE SELL AND IF WE ARE UNABLE TO SUCCESSFULLY COMPETE, OUR BUSINESS WILL BE ADVERSELY AFFECTED.

We compete in highly competitive and fragmented industries with numerous local and regional companies that provide some or all of the products

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and services we offer. We compete with national and international design companies, distributors and manufacturers of tags, packaging products, zippers and other trim items. Some of our competitors have greater name recognition, longer operating histories and greater financial and other resources than we do.

UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY MAY INCREASE OUR LITIGATION COSTS AND ADVERSELY AFFECT OUR SALES.

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

IF OUR PRODUCTS INFRINGE ANY OTHER PERSON'S PROPRIETARY RIGHTS, WE MAY BE SUED AND HAVE TO PAY LEGAL EXPENSES AND JUDGMENTS AND REDESIGN OR DISCONTINUE SELLING OUR PRODUCTS.

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

COUNTERFEIT PRODUCTS ARE NOT UNCOMMON IN THE APPAREL INDUSTRY AND OUR CUSTOMERS MAY MAKE CLAIMS AGAINST US FOR PRODUCTS WE HAVE NOT PRODUCED ADVERSELY IMPACTING US BY THESE FALSE CLAIMS.

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

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WE HAVE EXPERIENCED AND MAY CONTINUE TO EXPERIENCE MAJOR FLUCTUATIONS IN THE MARKET PRICE FOR OUR COMMON STOCK.

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

- o The failure of our quarterly operating results to meet expectations of investors or securities analysts;

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

IF WE NEED TO SELL OR ISSUE ADDITIONAL SHARES OF COMMON STOCK OR ASSUME ADDITIONAL DEBT TO FINANCE FUTURE GROWTH, OUR STOCKHOLDERS' OWNERSHIP COULD BE DILUTED OR OUR EARNINGS COULD BE ADVERSELY IMPACTED.

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

WE MAY NOT BE ABLE TO REALIZE THE ANTICIPATED BENEFITS OF ACQUISITIONS.

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

OUR ACTUAL TAX LIABILITIES MAY DIFFER FROM ESTIMATED TAX RESULTING IN UNFAVORABLE ADJUSTMENTS TO OUR FUTURE RESULTS.

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

WE HAVE ADOPTED A NUMBER OF ANTI-TAKEOVER MEASURES THAT MAY DEPRESS THE PRICE OF OUR COMMON STOCK.

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

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INSIDERS OWN A SIGNIFICANT PORTION OF OUR COMMON STOCK, WHICH COULD LIMIT OUR STOCKHOLDERS' ABILITY TO INFLUENCE THE OUTCOME OF KEY TRANSACTIONS.

As of March 27, 2009, our officers and directors and their affiliates owned approximately 16.5% of the outstanding shares of our common stock. The Dyne family, which includes Mark Dyne and Colin Dyne, who are also our directors, and Larry Dyne who is also an officer; beneficially owned approximately 12.4% of the outstanding shares of our common stock at March 27, 2009. Additionally, at March 27, 2009, Bluefin Capital, LLC, an affiliate of our lender, beneficially owned approximately 8.6% of the outstanding shares of our common stock. As a result, our lender, officers and directors and the Dyne family are able to exert considerable influence over the outcome of any matters submitted to a vote of the holders of our common stock, including the election of our Board of Directors. The voting power of these stockholders could also discourage others from seeking to acquire control of us through the purchase of our common stock, which might depress the price of our common stock.

WE MAY FACE INTERRUPTION OF PRODUCTION AND SERVICES DUE TO INCREASED SECURITY MEASURES IN RESPONSE TO TERRORISM.

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

IF WE ARE UNABLE TO REDEPLOY OUR MANUFACTURING ASSETS, OUR MANUFACTURING ASSETS VALUE WOULD BE ADVERSELY AFFECTED.

An important part of our operating strategy has been to re-deploy our former manufacturing assets into facilities in various geographical locations strategically located in close proximity to our more significant and important customers throughout Asia. If we cannot redeploy the assets, the carrying value of the assets would be adversely affected and could result in significant reductions in the carrying value of the assets and have an adverse effect on our results of operations. See Note 5 to the consolidated financial statements.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Our headquarters are located in the greater Los Angeles area, in Woodland Hills, California, where we lease approximately 8,800 square feet of administrative and product development space. In addition to the Woodland Hills facility, we lease 120 square feet of office space in New York, New York; 1,400 square feet of office space in Columbus, Ohio; 7,000 square feet of warehouse in Grover, North Carolina; 450 square feet of office in Mt. Holly, North Carolina; 3,400 square feet of warehouse space in Simi Valley, California; 23,809 square

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feet of office and warehouse space in Kwun Tong, Hong Kong; 9,900 square feet of office and showroom space in Shenzhen, China; office space square footage totaling 6,000 in various other cities in China; 1,000 square feet of office space in Bangalore, India; and 4,100 square feet of warehouse space in Santiago, Dominican Republic. The lease agreements related to these properties expire at various dates through September 2010. The building we owned in Kings Mountain, North Carolina was sold on October 22, 2008. We believe our existing facilities are adequate to meet our needs for the foreseeable future.

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ITEM 3. LEGAL PROCEEDINGS

On October 12, 2005, a shareholder class action complaint was filed in the United States District Court for the Central District of California ("District Court") against the Company, Colin Dyne, Mark Dyne, Ronda Ferguson and August F. Deluca (collectively, the "Individual Defendants" and, together with the Company, "Defendants"). The action is styled HUBERMAN V. TAG-IT PACIFIC, INC., ET AL., Case No. CV05-7352 R(Ex). On January 23, 2006, the District Court heard competing motions for appointment of lead plaintiff. The District Court appointed Seth Huberman as the lead plaintiff ("Plaintiff"). On March 13, 2006, Plaintiff filed an amended complaint. Plaintiff's amended complaint alleged that defendants made false and misleading statements about the Company's financial situation and the Company's relationship with certain of the Company's 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. The amended complaint purports to state claims under Section 10(b)/Rule 10b-5 and Section 20(a) of the Securities Exchange Act of 1934. On August 21, 2006, Defendants filed their answer to the amended complaint, denying the material allegations of wrongdoing. On February 20, 2007, the District Court denied class certification. On April 2, 2007, the District 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 with the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit"), and his opening appellate brief was filed on October 15, 2007. Defendants' brief was filed on November 28, 2007. The Ninth Circuit held oral arguments on October 23, 2008. On January 16, 2009, the Ninth Circuit issued an unpublished memorandum, instructing the District Court to certify a class, reversing the District Court's grant of summary judgment, and remanding for further proceedings consistent with its decision. The District Court has scheduled a status conference for May 4, 2009. The Company intends to vigorously defend this lawsuit; however, the outcome of this lawsuit or an estimate of the potential 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 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 the 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

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unable" to fulfill orders by refusing to fill orders with goods produced in the United States. We also filed a second civil action against Pro-Fit and related companies in the California Superior Court which was removed to the United States District Court, Central District of California. In April 2008, Pro-Fit and certain related companies were placed into administration in the United Kingdom. On May 21, 2008, the joint administrators for Pro-Fit and its related companies filed petitions under Chapter 15 of Title 11 of the United States Code for Pro-Fit and two related companies in the United States Bankruptcy Court for the Central District of California seeking recognition of the United Kingdom administration proceedings and related relief. As a consequence of the chapter 15 filings by the joint administrators, all litigation by us against Pro-Fit has been stayed. We have derived a significant amount of revenue from the sale of products incorporating the stretch waistband technology in the past 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 or resolved, may continue to incur additional legal fees in order to assert its rights and claims against Pro-Fit and any successor to those assets of Pro-Fit that are subject to our exclusive license and intellectual property agreement with Pro-Fit and to defend against any counterclaims.

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter of 2008.

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PART II

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

COMMON STOCK

Our common stock has been quoted on the OTC Bulletin Board under the symbol "TALN" since December 28, 2007. Our common stock was previously traded on the American Stock Exchange under the symbol "TAG." The following table sets forth the high and low sales prices for the Common Stock as reported by the American Stock Exchange and the OTC Bulletin Board during the periods indicated.

| | HIGH | LOW |
|------------------------------|---------|---------|
| | ----- | ----- |
| YEAR ENDED DECEMBER 31, 2008 | | |
| 1st Quarter..... | \$ 0.50 | \$ 0.22 |
| 2nd Quarter..... | 0.38 | 0.19 |

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| | | |
|------------------|------|------|
| 3rd Quarter..... | 0.29 | 0.10 |
| 4th Quarter..... | 0.25 | 0.10 |

YEAR ENDED DECEMBER 31, 2007

| | | |
|------------------|---------|---------|
| 1st Quarter..... | \$ 2.07 | \$ 1.06 |
| 2nd Quarter..... | 1.58 | 0.66 |
| 3rd Quarter..... | 1.14 | 0.70 |
| 4th Quarter..... | 0.82 | 0.30 |

On March 31, 2009 the closing sales price of our common stock as reported on OTC Bulletin Board was \$0.10 per share. As of March 31, 2009, there were 22 record holders of our common stock.

DIVIDENDS

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

PERFORMANCE GRAPH

The following graph sets forth the percentage change in cumulative total stockholder return of our common stock during the period from December 31, 2003 to December 31, 2008, compared with the cumulative returns of the American Stock Exchange Market Value (U.S. & Foreign) Index and The Dow Jones U.S. Clothing & Accessories Index. The comparison assumes \$100 was invested on December 31, 2003 in our common stock and in each of the foregoing indices. The stock price performance on the following graph is not necessarily indicative of future stock price performance.

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COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN

[GRAPHIC OMITTED]

| | Cumulative Total Return | | | | |
|-------------------------------------|-------------------------|--------|--------|--------|--------|
| | 12/03 | 12/04 | 12/05 | 12/06 | 12/07 |
| Talon International, Inc. | 100.00 | 100.22 | 8.02 | 22.94 | 9.02 |
| AMEX Composite | 100.00 | 124.13 | 155.00 | 184.30 | 217.52 |
| Dow Jones US Clothing & Accessories | 100.00 | 118.15 | 123.39 | 152.94 | 115.08 |

The information under this "Performance Graph" subheading shall not be deemed to be "filed" for the purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liabilities of such section, nor shall such information or exhibit be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Exchange Act, except as shall be expressly set forth by specific reference in such a filing.

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ITEM 6. SELECTED FINANCIAL DATA

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

| | YEARS ENDED DECEMBER 31, (In thousands except per share data) | | | |
|--|--|------------|-----------|-------------|
| | 2008 | 2007 | 2006 | 2005 |
| | ----- | ----- | ----- | ----- |
| CONSOLIDATED STATEMENT OF OPERATIONS DATA: | | | | |
| Total revenue | \$ 48,171 | \$ 40,530 | \$ 48,825 | \$ 47,331 |
| Income (loss) from operations (1) | \$ (5,962) | \$ (3,171) | \$ 1,331 | \$ (27,098) |
| Net income (loss) | \$ (8,359) | \$ (4,922) | \$ 309 | \$ (29,538) |
| Net income (loss) per share - basic | \$ (0.41) | \$ (0.24) | \$ 0.02 | \$ (1.62) |
| Net income (loss) per share - diluted .. . | \$ (0.41) | \$ (0.24) | \$ 0.02 | \$ (1.62) |
| Weighted average shares outstanding - basic | 20,291 | 20,156 | 18,377 | 18,226 |
| Weighted average shares outstanding - diluted | 20,291 | 20,156 | 18,956 | 18,226 |
| CONSOLIDATED BALANCE SHEET DATA: | | | | |
| Cash and cash equivalents | \$ 2,400 | \$ 2,919 | \$ 2,935 | \$ 2,277 |
| Total assets | \$ 15,603 | \$ 21,684 | \$ 25,694 | \$ 30,321 |
| Capital lease obligations, line of credit and notes payable | \$ 13,316 | \$ 12,696 | \$ 16,214 | \$ 16,001 |
| Stockholders' equity | \$ (8,762) | \$ (717) | \$ 1,686 | \$ 912 |
| Total liabilities and stockholders' equity | \$ 15,603 | \$ 21,684 | \$ 25,694 | \$ 30,321 |
| PER SHARE DATA: | | | | |
| Net book value per common share | \$ (0.43) | \$ (0.04) | \$ 0.09 | \$ 0.05 |
| Common shares outstanding | \$ 20,291 | \$ 20,291 | \$ 18,466 | \$ 18,241 |

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

| | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|------------|------------|-------|------------|------------|
| | ----- | ----- | ----- | ----- | ----- |
| Restructuring Charges | \$ -- | \$ -- | \$ -- | \$ (2,924) | \$ (414) |
| Inventory Impairment | \$ (692) | \$ -- | \$ -- | \$ (3,447) | \$ (2,700) |
| Losses from a former customer and impairment of related marketable securities | \$ (1,040) | \$ (1,088) | \$ -- | \$ -- | \$ (9,289) |
| Executive severance | \$ (724) | \$ -- | \$ -- | \$ -- | \$ -- |
| Related Party Note Impairment | \$ (474) | \$ -- | \$ -- | \$ -- | \$ -- |
| Impairment Charges Idle Equipment and Building | \$ (2,430) | \$ (127) | \$ -- | \$ -- | \$ -- |

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

OVERVIEW

The following management's discussion and analysis is intended to assist the reader in understanding our consolidated financial statements. This discussion is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and accompanying notes.

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

We plan to increase our global expansion of TALON zippers through the establishment of a network of Talon owned sales, distribution and manufacturing locations, distribution relationships and joint ventures. The network of these distributors and manufacturing joint ventures, in combination with Talon owned and affiliated facilities under the TALON brand, is expected to improve our time-to-market by eliminating the typical setup and build-out phase for new manufacturing capacity throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets.

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

Our TEKFIT services provide manufacturers with the patented technology, manufacturing know-how and materials required to produce pants incorporating an expandable waistband. These products were previously produced by several manufacturers for one single brand. In October 2006 our exclusive supply contract with this brand expired. Our efforts to expand this product offering to other customers have also been limited by a licensing dispute. As described more fully in this report under Item 3. "Legal Proceedings", we are presently in litigation with Pro-Fit Holdings Limited related to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured under Pro-Fit's patented technology. The revenues we derive from the sale of products incorporating the stretch waistband technology represented approximately 0.4% of our consolidated revenues for the year ended December 31, 2008 and 2% and 19% of consolidated revenues for the years ended December 31, 2007 and 2006. Our business prospects could be materially adversely affected if our dispute with Pro-Fit is not resolved in a manner favorable to us, or if we are unsuccessful

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in securing new customers to replace the revenues previously generated by the single brand.

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RESULTS OF OPERATIONS

NET SALES

For the years ended December 31, 2008, 2007 and 2006, total sales by geographic region based on customer delivery locations were as follows:

| | Year Ended December 31, | | |
|--------------------------|-------------------------|---------------------|---------------------|
| | 2008 | 2007 | 2006 |
| Sales: | | | |
| United States | \$ 3,332,257 | \$ 3,692,468 | \$ 4,223,052 |
| Hong Kong | 15,181,280 | 14,178,421 | 13,650,419 |
| Dominican Republic | 202,529 | 700,868 | 8,966,828 |
| China | 13,614,709 | 11,159,726 | 6,063,416 |
| India | 2,536,929 | 2,187,684 | 1,205,486 |
| Bangladesh | 2,434,382 | 1,924,943 | 2,070,349 |
| Mexico | 610,983 | 783,762 | 2,476,313 |
| Other | 10,257,911 | 5,901,683 | 10,169,139 |
| Total | \$48,170,980 | \$40,529,555 | \$48,825,002 |

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

| | Year Ended December 31, | | |
|-----------------------------------|-------------------------|---------------------|---------------------|
| | 2008 | 2007 | 2006 |
| Product Group Net Revenue: | | | |
| Talon zipper | \$28,428,885 | \$21,159,595 | \$17,005,203 |
| Trim | 19,537,302 | 18,688,698 | 22,502,947 |
| Tekfit | 204,793 | 681,262 | 9,316,852 |
| | \$48,170,980 | \$40,529,555 | \$48,825,002 |

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

The net increase of sales in 2008 versus 2007 was primarily due to an increase in Talon zipper sales (\$7.3 million or 34.4%) as a result of new brand nominations and sales within Southeast Asia, together with new and increased program sales in the Trim division (\$0.8 million or 4.5% increase) partially offset by a decline in sales of TEKFIT products.

The net decrease of sales in 2007 was primarily due to lower sales of waistband products as a result of the expiration in October of 2006 of our exclusive contract for these products (\$8.6 million), reduced operations in

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Mexico as we closed our operations there in 2005 and 2006 and production shifted from this area to Asia and lower trim sales due to fewer and smaller programs with our customers (\$3.8 million). Talon zipper sales continued to increase as we expanded our operations throughout China and southeast Asia (\$4.1 million), partially offsetting the declines from the Mexico and the Latin American regions for the Trim products and resulting in a net gain in Talon product sales overall.

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COST OF GOODS SOLD AND SELECTED OPERATING EXPENSES

The following table summarizes cost of goods sold and selected operating expenses for the years ended December 31, 2008, 2007 and 2006 (amounts in thousands) and the percentage change in such operating expenses as compared to the previous year:

| | 2008 | CHANGE | 2007 | CHANGE | 2006 |
|--|----------|--------|----------|--------|----------|
| | ----- | ----- | ----- | ----- | ----- |
| Sales | \$48,171 | 19% | \$40,530 | (17)% | \$48,825 |
| Cost of goods sold | 35,554 | 25% | 28,423 | (17)% | 34,356 |
| % of sales | 74% | | 70% | | 70% |
| Selling expenses | 3,104 | (1)% | 3,126 | 13% | 2,778 |
| % of sales | 6% | | 8% | | 6% |
| General and administrative expense ... | 12,006 | 10% | 10,937 | 6% | 10,360 |
| % of sales | 25% | | 27% | | 21% |
| Impairment of note receivable and | 1,040 | (4)% | 1,088 | 0% | -- |
| related loss on marketable securities- | | | | | |
| % of sales | 2% | | 3% | | 0% |
| Impairment loss on fixed assets | 2,430 | 1,813% | 127 | 0% | -- |
| % of sales | 5% | | .3% | | 0% |

COST OF GOODS SOLD

Cost of goods sold for the year ended December 31, 2008 increased \$7.1 million to 74% of sales versus 70% of sales in the year ended December 31, 2007. Our increased sales volumes and a product sales mix change to a higher proportion of lower margin Talon zipper products versus Trim components primarily increased costs of goods sold for 2008 by about \$6.2 million. In addition, we also recorded an additional \$0.7 million charge for inventory valuation reserves in 2008 versus \$0.1 million in 2007 and also experienced \$0.3 million in 2008 in increased freight and manufacturing costs.

Cost of goods sold for the year ended December 31, 2007, declined \$5.9 million or 17% as compared to the year ended December 31, 2006, primarily a result of the 17% decrease in sales. The reduction in cost of goods sold in 2007 was principally attributable to lower overall sales volumes and lower direct margin resulting from a change in the mix in sales by product group, partially

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offset by reduced distribution charges since more products were sourced and delivered within the same marketplace, reduced manufacturing and assembly overhead costs, lower inventory valuation reserve charges and management charges as inventory levels have been reduced and turns accelerated.

SELLING EXPENSES

Selling expenses for the year ended December 31, 2008 remained relatively unchanged in dollar terms as compared to 2007 but decreased as a percentage of sales by 1.3% to 6.4%. Our production samples increased as we targeted new customers and programs within the industry for growth offset by lower marketing costs.

Selling expenses for the year ended December 31, 2007 increased \$0.4 million or 12.0% as compared 2006 as a result of the increased number of sales offices and employees within Asia and their associated compensation (\$0.4 million) and facilities, travel and administrative costs (\$0.4 million), offset by lower marketing costs (\$0.1 million) and lower royalty fees on waistband products (\$0.3 million).

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GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses for the year ended December 31, 2008 of \$12.0 million was \$1.1 million higher than 2007. The general and administrative expenses in 2008 include \$0.7 million in compensation and related costs mainly associated with the severance of our former chief executive officer and chief operating officer while the 2007 expenses included \$0.9 million of professional costs related to consulting contracts with two former directors. Other major factors affecting general and administrative expenses in 2008 were higher salaries, benefits, travel and facility costs of \$.3 million from expanded operations in Asia which supported the higher sales; higher depreciation of \$0.2 million primarily from idle equipment; higher bad debt expense of \$0.4 million primarily due to the impairment of a related party note receivable; higher stock based compensation of \$0.2 million associated with new incentive option grants and \$0.1 million of higher sampling costs associated with new programs.

General and administrative expenses for the year ended December 31, 2007 of \$10.9 million remained relatively unchanged from 2006 excluding bad expense (recoveries). General and administrative expenses were affected by a \$0.2 million increase from 2006 attributable to increased employee costs due to the continued expansion within Asia and increased professional and audit fees of \$0.9 million; offset by reduced legal costs of \$0.6 million, \$0.1 million decrease in insurance costs and \$0.4 million reduction in management incentive bonuses, commissions and stock-based compensation. Included in professional and audit fees were non-recurring charges of \$0.6 million related to exiting consulting contracts with two former directors. Bad debt expense for the year ended December 31, 2007 increased by \$0.6 million as a result of \$0.1 million in bad debt provisions in 2007 compared to bad debt recoveries of \$0.5 million in 2006

IMPAIRMENT OF NOTE RECEIVABLE AND RELATED LOSS ON MARKETABLE SECURITIES

Loss on marketable securities for the year ended December 31, 2008 includes \$1.0 million in a valuation reserve for the full value of our investment in marketable securities that we received in exchange for the Azteca Production International, Inc. note receivable. Operating expense in 2007

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included \$1.1 million in bad debt reserve provisions associated with the note receivable due from Azteca Production International, Inc. See Note 3 to the consolidated financial statements.

IMPAIRMENT LOSS ON FIXED ASSETS

Operating expenses for the years ended 2008 and 2007 include \$2.4 million and \$0.1 million, respectively, in impairment valuations for certain equipment and building. See Note 5 to the consolidated financial statements.

INTEREST EXPENSE AND INTEREST INCOME

Interest expense for the year ended December 31, 2008 increased approximately \$0.6 million or 30.1% to \$2.5 million, as compared to \$1.9 million in 2007. In 2008, we recorded a full year of interest expense and amortization of deferred financing costs for our revolving credit and term notes, which carry a higher cost, as compared to 2007 which included only a partial year of interest related to our revolving credit and term notes and a partial year of our previous secured convertible notes payable. These secured convertible notes payable were paid off early in the third quarter of 2007. Interest expense also included \$1.2 million in amortized deferred financing charges, compared to \$0.7 million in 2007, associated with the fair value of equity components issued in connection with the debt facility. Interest income for the year ended December 31, 2008 decreased about \$178,000 to \$64,000 as compared to \$242,000 in 2007 primarily due to the write-off of the Azteca note receivable. See Note 3 to the consolidated financial statements.

Interest expense for the year ended December 31, 2007 increased approximately \$0.6 million or 41.6% to \$1.9 million from \$1.4 million during 2006 as a result of higher average debt levels in 2007 compared to 2006. For the year ended December 31, 2007 interest expense included \$725,000 in amortized deferred financing charges and higher costs on our revolving credit and term notes as compared to our previous secured convertible notes payable. During the third quarter 2007, we charged off approximately \$111,000 in unamortized deferred financing costs and discounts related to and in conjunction with the

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early payment of the secured convertible promissory notes in July 2007. Interest income for the year ended December 31, 2007 of \$242,000 decreased approximately \$126,000 or 34.2% from \$368,000 during 2006 related primarily to the elimination of the note receivable discussed in Note 4 to the consolidated financial statements.

INCOME TAXES

The net tax benefit for income taxes was approximately \$40,000 in 2008. It includes a charge for foreign withholding taxes arising from our domestic royalty charges to our foreign operations and domestic state income taxes offset by a tax benefit from our operating loss carry forwards in Hong Kong and India. There is not sufficient evidence to determine that it is more likely than not that the Company will be able to utilize its domestic net operating loss carry forwards to offset future taxable income and as a result, these losses have a full valuation reserve against them.

The provision for income taxes was \$0.1 million for the year ended December 31, 2007. It principally includes income tax provisions from operations in China and India; offset by an income tax benefit from net operating loss carry forward in Hong Kong.

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Income tax provisions for the year ended December 31, 2006 principally include a royalty tax from the Inland Revenue Department in Hong Kong applicable to 2005, net of an estimated tax benefit for 2006 foreign losses and minimum federal and state filing fees.

LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes selected financial data (amounts in thousands):

| | DECEMBER 31, 2008 | DECEMBER 31, 2007 |
|--------------------------------------|----------------------|----------------------|
| | ----- | ----- |
| Cash and cash equivalents | \$ 2,400 | \$ 2,919 |
| Total assets | 15,603 | 21,684 |
| Current liabilities..... | 10,899 | 9,845 |
| Non-current liabilities | 13,466 | 12,556 |
| Stockholders' equity (deficit) | (8,762) | (717) |

CASH AND CASH EQUIVALENTS

Our cash is held with financial institutions. Substantially all of the balances at December 31, 2008 and 2007 are in excess of federally insured limits, and there is no restricted cash.

Cash and cash equivalents for the year ended December 31, 2008 decreased by \$0.5 million from December 31, 2007 due to a decrease in cash generated by operating activities, net of proceeds from the disposition of the building in North Carolina and lower overall net cash used in financing activities.

Cash and cash equivalents for the year ended December 31, 2007 decreased by \$0.1 million from December 31, 2006 principally arising from cash generated by operating activities, net of payments on notes payable and capital leases.

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CASH FLOWS

The following table summarizes our cash flow activity for the years ended December 31, 2008, 2007 and 2006 (amounts in thousands):

| | 2008 | 2007 | 2006 |
|---|--------|----------|----------|
| | ----- | ----- | ----- |
| Net cash provided by operating activities | \$ 363 | \$ 2,137 | \$ 1,794 |
| Net cash used in investing activities | (133) | (725) | (345) |
| Net cash used in financing activities | (779) | (1,433) | (791) |
| Net increase (decrease) in cash and cash equivalents | (549) | (21) | 657 |

OPERATING ACTIVITIES

Cash provided by operating activities was \$0.4 million for the year ended December 31, 2008. The cash generated by operating activities during 2008 resulted primarily from reductions in inventory net of reserves of \$0.8 million,

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prepaid expenses of \$0.5 million and an increase in accounts payables and accrued expenses of \$1.3 million.

Cash provided by operating activities was \$2.1 million for the year ended December 31, 2007. The cash generated by operating activities during 2007 resulted primarily from reductions in accounts receivable net of applied reserves of \$3.3 million, \$0.6 million in reductions in inventory net of reserves applied, \$0.6 million in collections on the note receivable and increases in accounts payable of \$2.1 million offset by increases in prepaid assets and other assets of approximately \$0.5 million. Included in the net reserves was the write-off of the Azteca note and subsequent payment in shares as discussed in Note 3 to the consolidated financial statements.

Cash provided by operating activities was \$1.8 million for the year ended December 31, 2006. The cash generated by operating activities during 2006 resulted primarily from net earnings (before non-cash expenses) of approximately \$2.3 million; reductions in inventory net of applied reserves of \$2.5 million; \$1.0 million in reductions in accounts receivable net of reserves applied; and approximately \$0.6 million in collections on the note receivable; net of reductions in accounts payable of \$2.6 million; repayments on notes payable of \$0.9 million and reductions in other liabilities, net of approximately \$1.2 million. The note receivable collections are associated with unsettled accounts receivable from a former customer converted into a note receivable in early 2006. The repayments on the notes payable are principally associated with previously accrued legal expenses converted into a note payable in May of 2006. Payments on the note payable are made from collections received from the note receivable which is pledged to the note payable. These notes are non-recurring settlements associated primarily with sales and expenses from 2005 and prior transactions.

The net decrease in inventory of \$2.5 million for the year ended December 31, 2006 reflects our efforts to dispose of lower slower-moving and obsolete inventory components. The cost of net inventories eliminated during 2006 was \$8.6 million, and reserves applicable to this inventory of \$6.1 million were applied to these dispositions. Accounts receivable for the year ended December 31, 2006 declined by \$2.1 million primarily as a result of improved collections and faster turns of accounts receivable and by approximately \$0.7 million in accounts written-off. Accounts receivable reserves declined by \$1.1 million from the write-off of uncollectible accounts and by approximately \$0.4 million from the collection of accounts reserved for in prior years. In addition, during 2006 collections of accounts written-off in prior years was \$0.5 million.

INVESTING ACTIVITIES

Cash flows from investing activities include the sale of the North Carolina property with proceeds of \$0.7 million offset by capital expenditures of \$0.8 million primarily for new office space in Asia and improvements in our technology systems.

Net cash used in investing activities for the year ended December 31, 2007 and 2006 consisted of capital expenditures of \$0.7 million and \$0.3 million, respectively, for leasehold improvements, office equipment for new employees, improvements in our technology systems and a marketing website acquisition.

FINANCING ACTIVITIES

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Net cash used in financing activities for the year ended December 31, 2008 was \$0.8 million with \$1.2 million in revolver note borrowings and \$2.0 million used for repayment of the revolver, term note and other notes payable and capital lease obligations.

Net cash used in financing activities for the year ended December 31, 2007 was \$1.4 million. During 2007, \$13.8 million (net of issuance costs) was provided by the issuance of common stock and warrants and by borrowings under a new debt facility (see below) designated to pay off our previously existing convertible promissory notes and to provide funds for future growth. The proceeds from this debt facility were used to pay the \$12.5 million of secured convertible promissory notes, and \$1.0 million was used to pay a related party note of \$0.6 million and associated accrued interest. Approximately \$1.2 million was used primarily for the repayment of borrowings under capital leases and notes payable and \$0.5 million in initial borrowings under the revolving note were repaid.

Net cash used in financing activities for the years ended December 31, 2006 reflects the repayment of notes payable and capital lease obligations.

On June 27, 2007, we 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. Bluefin Capital subsequently assigned its rights and obligations under the credit facility agreements to an affiliate, CVC California, LLC ("CVC"). The revolving credit portion of the facility, as amended, permits borrowings based upon a formula including 85% of eligible receivables and 55% of eligible inventory and provides for monthly interest payments at the prime rate (5.25% at December 31, 2008) 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 our assets. There was \$3,000 and \$879,000 in available borrowings at December 31, 2008 and December 31, 2007, respectively.

In connection with the Revolving Credit and Term Loan Agreement, we issued 1,500,000 shares of common stock to the lender for \$0.001 per share, and issued warrants to purchase 2,100,000 shares of common stock. The warrants were exercisable over a five-year period and initially 700,000 warrants were exercisable at \$0.95 per share; 700,000 warrants were exercisable at \$1.05 per share; and 700,000 warrants were exercisable at \$1.14 per share. The warrants did not require cash settlements. The relative fair value of the equity (\$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 is being 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 as a reduction to the face value of the note on the balance sheet.

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

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of the note.

On April 3, 2008, we executed a further amendment to our existing loan agreement. The amendment included a redefining of the EBITDA covenants, and the cancellation of the common stock warrants previously issued to Bluefin Capital in exchange for our issuance of an additional note payable to the lender for \$1.0 million. The note bears interest at 8.5% and both the note and accrued interest are payable at maturity on June 30, 2010. In addition, our borrowing base was modified in this amendment by increasing the allowable portion of inventory held by third party vendors to \$1.0 million with no more than \$500,000 held at any one vendor and increasing the percentage of accounts receivable to be included in the borrowing base to 85%. We incurred a one-time modification

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fee of \$145,000 to secure the amendment of the agreement. The new relative fair value of the equity issued with this debt of \$2,542,000, including the modifications in this amendment and a reduction for financing costs, is being amortized over the term of the note.

Under the terms of the credit agreement, as amended, we are required to meet certain coverage ratios, among other restrictions including a restriction from declaring or paying a dividend prior to repayment of all the obligations. The financial covenants, as amended, require that we maintain at the end of each fiscal quarter "EBITDA" (as defined in the agreement) in excess of the principal and interest payments for the same period of not less than \$1.00 and in excess of ratios set out in the agreement for each quarter. We failed to satisfy the minimum EBITDA requirement for quarter ended December 31, 2008, and a waiver fee was accrued and the requirement delayed to the next quarter. In the event that we fail to satisfy the minimum EBITDA requirement for a quarter, a waiver fee of 1% of the debt commitment may be paid and the requirement delayed to the next quarter. If two consecutive quarters fail to meet the minimum EBITDA the waiver fee increases to 2%. If three consecutive quarters fail to meet the minimum EBITDA, or we do not pay the waiver fee, the credit agreement would be in default and the lender may demand immediate repayment of the full amount of the notes outstanding, which if we were unable to obtain a waiver or amend these covenants, we may be unable to continue as a going concern, see Note 2 to our consolidated financial statements.

On March 31, 2009 we completed an amendment to our existing revolving credit and term loan agreement with CVC. The amendment provided for the following: issuance of an additional term note to CVC in the principal amount of \$225,210 in lieu of paying a cash waiver fee in connection with our failure to satisfy the EBITDA requirements for the quarter ended December 31, 2008 and March 31, 2009; deferral of the term note quarterly interest payment of \$215,000 due April 1, 2009; a temporary increase to the borrowing base formulas and calculations under the revolving credit facility; the re-lending by CVC of \$125,000 under the term loan portion of credit facility; a consent to allow us to sell equipment that has been designated as held for sale more fully described in Note 5 to the consolidated financial statements; and the granting to CVC of the right to designate a non-voting observer to attend all meetings of our Board of Directors.

We financed building, land and equipment purchases through notes payable and capital lease obligations expiring through June 2011. The building and land mortgage were fully paid when the property was sold in October 2008. The remaining obligations bear interest at rates of 6.6% and 12.1% per annum, and under these obligations, we are required to make monthly payments of principal and interest.

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The outstanding balance including accrued interest of our demand notes payable to related parties at December 31, 2008 and 2007 was \$222,000 and \$213,000, respectively. The demand notes of \$85,000 bear interest at 10%, have no scheduled monthly payments and are due within fifteen days from demand.

We believe that our existing cash and cash equivalents and our anticipated cash flows from our operating activities will be sufficient to fund our minimum working capital and capital expenditure needs, as well as provide for our scheduled debt service requirements, for at least the next twelve months. This conclusion is based on the belief that our operating assets, strategic plan, operating expectations and operating expense structure will provide for sufficient profitability from operations before non-cash charges to fund our operating capital requirements and achieve our debt service requirements, and that our existing cash and cash equivalents will be sufficient to fund our expansion and capital requirements.

We have historically satisfied our working capital requirements primarily through cash flows generated from operations and borrowings under our credit facility. As we continue to expand globally in response to the industry trend to outsource apparel manufacturing to offshore locations, our foreign customers, some of which are backed by U.S. brands and retailers, are increasing. Our revolving credit facility provides limited financing secured by our accounts receivable, and our current borrowing capability may not provide the level of financing we need to continue in or to expand into additional foreign markets. We are continuing to evaluate non-traditional financing of our foreign assets and equity transactions to provide capital needed to fund our expansion and operations.

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If we experience greater than anticipated reductions in sales, we may need to raise additional capital, or further reduce the scope of our business in order to fully satisfy our future short-term liquidity requirements. If we cannot raise additional capital or reduce the scope of our business in response to a substantial decline in sales, we may default on our credit agreement.

The extent of our future long-term capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of future acquisitions, our borrowing base availability limitations related to eligible accounts receivable and inventories and our expansion into foreign markets. Our need for additional long-term financing includes the integration and expansion of our operations to exploit our rights under our Talon trade name, the expansion of our operations in the Asian, Central and South American and Caribbean markets and the further development of our waistband technology. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise additional debt or equity financing in order to provide for our operations. We are continually evaluating various financing strategies to be used to expand our business and fund future growth or acquisitions. There can be no assurance that additional debt or equity financing will be available on acceptable terms or at all. If we are unable to secure additional financing, we may not be able to execute our plans for expansion, including expansion into foreign markets to promote our TALON brand trade name, and we may need to implement additional cost savings initiatives, any of which could have a material adverse effect on our financial condition and results of operations and affect our ability to operate as a going concern. See Note 2 to the consolidated financial statements.

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CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

The following summarizes our contractual obligations at December 31, 2008 and the effects such obligations are expected to have on liquidity and cash flow in future periods:

| Contractual Obligations | Payments Due by Period | | | | |
|---------------------------|------------------------|---------------------|--------------|--------------|------------------|
| | Total | Less than 1 Year | 1-3 Years | 4-5 Years | After 5 Years |
| Demand notes payable to | | | | | |
| related parties (1) .. | \$ 222,300 | \$ 222,300 | \$ -- | \$ -- | \$ -- |
| Capital lease obligations | 192,900 | 190,900 | 2,000 | -- | -- |
| Operating leases | 878,200 | 570,300 | 304,100 | 3,800 | -- |
| Revolver & Term Note | 16,702,100 | 1,125,400 | 15,576,700 | -- | -- |
| Other notes payable | 146,700 | 146,700 | -- | -- | -- |
| Total Obligations .. | \$18,142,200 | \$ 2,255,600 | \$15,882,800 | \$ 3,800 | \$ -- |

(1) The majority of notes payable to related parties are due on demand with the remainder due and payable on the fifteenth day following the date of delivery of written demand for payment and include accrued interest payable through December 31, 2008.

At December 31, 2008 and 2007, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

RELATED PARTY TRANSACTIONS

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

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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assets and liabilities, the disclosure of contingent liabilities and the reported amounts of revenue and expense. Actual results could differ from those estimates.

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

- o Accounts and note receivable balances are evaluated on a continual basis and allowances are provided for potentially uncollectible accounts based on management's estimate of the collectability of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of its ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known.

The net bad debt expenses, recoveries and allowances for the twelve months ended December 31, 2008, 2007 and 2006 are as follows:

| | 2008 | 2007 | 2006 |
|---|-----------|------------|--------------|
| | ----- | ----- | ----- |
| Net bad debt expenses for accounts receivable | \$ 74,500 | \$ 186,700 | \$ (513,300) |
| Bad debt expense for notes receivable, including related party | 474,000 | 1,087,700 | -- |
| Recoveries | 3,050 | 19,500 | 711,400 |
| Allowance for doubtful accounts | 217,300 | 140,500 | 71,500 |
| Allowance for doubtful accounts, related party | 474,000 | -- | -- |

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

The inventory reserve expenses and allowances for the twelve months ended December 31, 2008, 2007 and 2006 are as follows:

| | Twelve Months Ended December 31, | | |
|--|----------------------------------|------------|------------|
| | 2008 | 2007 | 2006 |
| | ----- | ----- | ----- |
| Inventory valuation expense | \$ 692,000 | \$ 148,000 | \$ 557,000 |
| Allowance for inventory valuation reserves | 1,211,000 | 1,019,000 | 1,242,000 |

- o We record deferred tax assets arising from temporary timing differences between recorded net income and taxable net income when and if we believe that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. If we determine that we may not realize all of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. We believe that our estimate of deferred tax assets and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. See Note 12 to the consolidated financial statements.
- o 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. Long-lived assets were evaluated, and we determined that certain components of idle equipment would not either be effectively redeployed or would be sold or disposed. Accordingly, the Company took \$2,430,000 in impairment charges for the period ending December 31, 2008. See Note 5 to the consolidated financial statements.
- o Sales are recognized when persuasive evidence of an arrangement exists, product title has passed, pricing is fixed or determinable and collection is reasonably assured. Sales

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resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of

the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns and the cost of products sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances, which returns have been insignificant.

- o 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.

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NEW ACCOUNTING PRONOUNCEMENTS

In December 2008, FASB issues FASB Staff Position (FSP) 140-4 and FIN 46(R)-8, Disclosures by Public Entities about Transfers of Financial Assets and Interests in Variable Interest Entities. The purpose of this FSP is to promptly increase disclosures by public entities and enterprises until the pending amendments to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, (FAS 140) and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, (FIN 46(R)) are finalized and approved by the FASB. The FSP is effective for reporting periods (interim and annual) ending after December 15, 2008. We adopted this FSP for our year ended December 31, 2008 and the adoption did not have any impact on our consolidated financial statements.

In May 2008, FASB issued FASB Staff Position No. APB 14-1 "Accounting for Convertible Debt Instruments That May Be Turned Into Cash Upon Conversion" ("APB 14-1"). APB 14-1 addresses that convertible debt instruments may be settled in cash upon conversion (including partial cash settlement). Additionally, APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. APB 14-1 is to be applied retrospectively for the first fiscal year beginning on or after December 15, 2008 and interim periods within the fiscal year. Early adoption is not permitted. We do not believe FASB Staff Position APB 14-1 will have a material impact on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411. We do not believe SFAS 162 will have any impact on our

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consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, DISCLOSURES ABOUT DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES - AN AMENDMENT OF FASB STATEMENT NO. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We do not believe SFAS 161 will have a material impact on our consolidated financial statements.

In February 2008, the FASB issued FASB Staff Position 157-2, Effective Date of FASB Statement No. 157 which delays the effective date of SFAS No. 157 to January 1, 2009, for the Company, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We believe the adoption of the delayed items of SFAS No. 157 will not have a material impact on our consolidated financial statements.

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.

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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.

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 have adopted SFAS 159 in the first quarter of 2008. It did not have any impact on our consolidated financial statements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

All of our sales are denominated in United States dollars or the currency of the country in which our products originate. We are exposed to market risk for fluctuations in the foreign currency exchange rates for certain product purchases that are denominated in Hong Kong dollars and Chinese Yuan. We do not intend to purchase contracts to hedge the exchange exposure for future product purchases. There were no hedging contracts outstanding as of December 31, 2008. Currency fluctuations can increase the price of our products to foreign customers which can adversely impact the level of our export sales from time to time. The majority of our cash equivalents are held in United States dollars in various bank accounts and we do not believe we have significant market risk exposure with regard to our investments. At December 31, 2008, the Revolving Credit Note of \$4.6 million was subject to interest rate fluctuations. A one percentage point increase in interest rates would result in an annualized increase to interest expense of approximately \$46,000 on our variable rate borrowings.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the consolidated balance sheets of Talon International, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and convertible redeemable preferred stock, and cash flows for each of the three years in the period ended December 31, 2008. Our audits also included the financial statement schedules of Talon International, Inc., listed in Item 15(a). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a

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test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Talon International, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements, taken as a whole, presents fairly in all material respects the information set forth therein.

We were not engaged to examine management's assertion about the effectiveness of Talon International, Inc.'s internal control over financial reporting as of December 31, 2008, included in the accompanying Management's Report on Internal Control Over Financial Reporting and accordingly, we do not express an opinion thereon.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, for the year ended December 31, 2008, the Company incurred a net loss of \$8,356,786. In addition, the Company had an accumulated deficit of \$63,651,032 at December 31, 2008. These factors, among others, as discussed in Note 2 to the financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ SingerLewak LLP

 SINGERLEWAK LLP
 Los Angeles, California
 April 6, 2009

TALON INTERNATIONAL, INC.
 CONSOLIDATED BALANCE SHEETS

| | December 31, 2008 | December 31, 2007 |
|--|----------------------|----------------------|
| | ----- | ----- |
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 2,399,717 | \$ 2,918,858 |
| Marketable Securities, net of valuation reserves | -- | 1,040,000 |
| Accounts Receivable, net | 3,856,613 | 3,504,351 |
| Inventories, net | 1,669,149 | 2,487,427 |
| Prepaid expenses and other current assets | 473,955 | 945,566 |
| | ----- | ----- |

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| | | |
|--|---------------|---------------|
| Total current assets | 8,399,434 | 10,896,202 |
| Property and equipment, net | 2,084,244 | 5,210,446 |
| Fixed Assets held for sale | 407,655 | 700,000 |
| Due from related parties | 200,000 | 625,454 |
| Intangible assets, net | 4,110,751 | 4,110,751 |
| Other assets | 400,494 | 140,782 |
| | ----- | ----- |
| Total assets | \$ 15,602,578 | \$ 21,683,635 |
| | ===== | ===== |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 7,674,768 | \$ 6,249,618 |
| Other accrued expenses and legal costs | 2,675,756 | 2,759,868 |
| Demand notes payable to related parties | 222,264 | 213,091 |
| Current portion of capital lease obligations ... | 182,444 | 323,317 |
| Current portion of notes payable | 144,064 | 299,108 |
| | ----- | ----- |
| Total current liabilities | 10,899,296 | 9,845,002 |
| Capital lease obligations, less current portion .. | 1,910 | 189,705 |
| Notes payable, less current portion | -- | 848,484 |
| Revolver note payable | 4,638,988 | 3,807,806 |
| Term note payable, net of discount | 8,067,428 | 7,014,301 |
| Other long term liabilities | 756,888 | 695,687 |
| | ----- | ----- |
| Total liabilities | 24,364,510 | 22,400,985 |
| Commitments and contingencies (Note 14) | | |
| 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, 2008 and December 31, 2007, respectively | 20,291 | 20,291 |
| Additional paid-in capital | 54,769,072 | 54,510,161 |
| Accumulated deficit | (63,651,032) | (55,292,246) |
| Accumulated other comprehensive income | 99,737 | 44,444 |
| | ----- | ----- |
| Total stockholders' equity (deficit) | (8,761,932) | (717,350) |
| | ----- | ----- |
| Total liabilities and stockholders' equity | \$ 15,602,578 | \$ 21,683,635 |
| | ===== | ===== |

See accompanying notes.

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| | Year Ended December 31, | | |
|--|-------------------------|----------------|------------|
| | 2008 | 2007 | 2006 |
| Net sales | \$ 48,170,980 | \$ 40,529,555 | 48,825,002 |
| Cost of goods sold | 35,553,857 | 28,422,820 | 34,356,034 |
| Gross profit | 12,617,123 | 12,106,735 | 14,468,968 |
| Selling expenses | 3,103,529 | 3,125,634 | 2,777,772 |
| General and administrative expenses | 12,005,971 | 10,937,223 | 10,359,540 |
| Impairment of marketable securities and related note receivable | 1,040,000 | 1,087,653 | -- |
| Impairment loss on fixed assets | 2,429,506 | 126,904 | -- |
| Total operating expenses | 18,579,006 | 15,277,414 | 13,137,312 |
| Income (loss) from operations | (5,961,883) | (3,170,679) | 1,331,656 |
| Interest expense, net | 2,436,675 | 1,680,079 | 988,453 |
| Income (loss) before income taxes | (8,398,558) | (4,850,758) | 343,203 |
| Provision for (benefit from) income taxes . | (39,772) | 70,949 | 33,900 |
| Net income (loss) | \$ (8,358,786) | \$ (4,921,707) | \$ 309,303 |
| Basic income (loss) per share | \$ (0.41) | \$ (0.24) | \$ 0.02 |
| Diluted income (loss) per share | \$ (0.41) | \$ (0.24) | \$ 0.02 |
| Basic weighted average shares outstanding . | 20,291,433 | 20,155,563 | 18,377,484 |
| Diluted weighted average shares outstanding | 20,291,433 | 20,155,563 | 18,955,796 |

See accompanying notes.

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TALON INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2008, 2007 AND 2006

| Common Stock | | Preferred Stock Series A | |
|--------------|--------|-----------------------------|--------|
| Shares | Amount | Shares | Amount |
| ----- | ----- | ----- | ----- |

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| | | | | |
|---|------------|-----------|----|-------|
| BALANCE, JANUARY 1, 2006 .. | 18,241,045 | \$ 18,241 | -- | \$ -- |
| Common stock issued for services | 225,388 | 225 | -- | -- |
| Stock based compensation | -- | -- | -- | -- |
| Net income | -- | -- | -- | -- |
| ----- | | | | |
| 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 | -- | -- | -- | -- |
| Foreign currency translation | -- | -- | -- | -- |
| Adoption of FIN 48 | -- | -- | -- | -- |
| Net loss | -- | -- | -- | -- |
| ----- | | | | |
| BALANCE, DECEMBER 31, 2007 | 20,291,433 | 20,291 | -- | -- |
| Warrant fair value adjustment | -- | -- | -- | -- |
| Stock based compensation | -- | -- | -- | -- |
| Foreign currency translation | -- | -- | -- | -- |
| Net loss | -- | -- | -- | -- |
| ----- | | | | |
| BALANCE, DECEMBER 31, 2008 | 20,291,433 | \$ 20,291 | -- | \$ -- |
| ===== | | | | |

| | Additional Paid-In Capital | Other Comprehensive Income | Retained Earnings (Deficit) | Total |
|---|----------------------------------|----------------------------------|-----------------------------------|-------------|
| | ----- | ----- | ----- | ----- |
| BALANCE, JANUARY 1, 2006 .. | \$ 51,327,878 | \$ -- | \$ (50,434,042) | \$ 912,077 |
| Common stock issued for services | 102,504 | -- | -- | 102,729 |
| Stock based compensation | 362,120 | -- | -- | 362,120 |
| Net income | -- | -- | 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 |
| 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) |
| Warrant fair value adjustment | (148,302) | -- | -- | (148,302) |
| Stock based compensation | 407,213 | -- | -- | 407,213 |
| Foreign currency translation | -- | 55,293 | -- | 55,293 |
| Net loss | -- | -- | (8,358,786) | (8,358,786) |

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| | | | | |
|----------------------------|---------------|-----------|-----------------|----------------|
| BALANCE, DECEMBER 31, 2008 | \$ 54,769,072 | \$ 99,737 | \$ (63,651,032) | \$ (8,761,932) |
|----------------------------|---------------|-----------|-----------------|----------------|

See accompanying notes

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TALON INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Year Ended December 31, 2008 | Year Ended December 31, 2007 |
|---|------------------------------------|------------------------------------|
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$ (8,358,786) | \$ (4,921,707) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,079,441 | 1,168,434 |
| Amortization of deferred financing cost and debt discounts | 1,186,837 | 736,042 |
| Common stock and warrants issued for services | -- | -- |
| Stock based compensation | 407,213 | 245,000 |
| Additions (recoveries) to allowance for doubtful accounts | 548,519 | 1,274,406 |
| Additions to inventory valuation reserve | 692,382 | 148,000 |
| Impairment of marketable securities and fixed assets | 3,469,506 | 126,904 |
| Loss from disposal of assets | 49,000 | 58,076 |
| Changes in operating assets and liabilities: | | |
| Accounts and notes receivable, including related parties . | (419,891) | 1,048,662 |
| Note receivable collections | -- | 596,491 |
| Inventories | 125,896 | 415,793 |
| Prepaid expenses and other current assets | 474,317 | (404,532) |
| Other assets | (249,709) | (118,499) |
| Accounts payable | 1,390,674 | 2,070,784 |
| Other accrued expenses | (32,191) | (306,636) |
| Repayment of notes payable converted from accounts payable | -- | -- |
| Net cash provided by (used in) operating activities | 363,208 | 2,137,218 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of equipment | 686,510 | -- |
| Acquisition of property and equipment | (819,876) | (725,498) |
| Net cash used in investing activities | (133,366) | (725,498) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options and warrants | -- | 42,746 |
| Proceeds from issuance of stock options and warrants, net of issuance costs | -- | 2,463,017 |
| Revolver note borrowings | 1,200,000 | 4,307,806 |
| Repayment of revolver note borrowings | (521,722) | (500,000) |
| Term note borrowings, net of issuance costs | -- | 7,131,720 |
| Payments on term note | (125,000) | (449,840) |
| Proceeds from other notes including related party | -- | 291,753 |

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| | | |
|---|--------------|--------------|
| Payments of demand note payable to related party | -- | (579,794) |
| Payments of notes payable | (1,003,528) | (13,687,882) |
| Payments of capital lease obligations | (328,668) | (452,232) |
| | ----- | ----- |
| Net cash (used in) provided by financing activities | (778,918) | (1,432,706) |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | (549,076) | (20,986) |
| Net effect of foreign currency exchange translation on cash ... | 29,935 | 5,171 |
| | ----- | ----- |
| Cash and cash equivalents, beginning of year | 2,918,858 | 2,934,673 |
| | ----- | ----- |
| Cash and cash equivalents, end of year | \$ 2,399,717 | \$ 2,918,858 |
| | ===== | ===== |

See accompanying notes.

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| | | |
|--|------------------------------------|------------------------------------|
| TALON INTERNATIONAL, INC. Consolidated Statements of Cash Flows SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | Year Ended December 31, 2008 | Year Ended December 31, 2007 |
| Cash received (paid) during the year for: | ----- | ----- |
| Interest paid | \$ (1,301,790) | \$ (1,166,333) |
| Interest received | \$ 15,509 | \$ 182,263 |
| Income taxes paid | \$ (183,970) | (90,530) |
| Non-cash financing activity: | | |
| Notes payable issued in modification of loan agreement | \$ 1,000,000 | \$ -- |
| Debt modification fee | \$ 145,000 | \$ -- |
| Deferred financing cost | \$ -- | \$ 217,302 |
| Effect of foreign currency translation on net assets | \$ 55,293 | \$ 10,728 |
| Notes receivable, converted to marketable securities | \$ 1,040,000 | \$ -- |
| Trade payable & accrued legal, converted to notes payable.. | \$ -- | \$ -- |
| Capital lease obligation | \$ -- | \$ 57,793 |

See accompanying notes.

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TALON INTERNATIONAL, INC.
NOTES TO
CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1-- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS

Talon International, Inc. (together with its subsidiaries, the "Company") is an apparel company that specializes in the distribution of trim items to manufacturers of fashion apparel, specialty retailers and mass

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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.

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 operations in the period incurred. During 2008, 2007 and 2006, 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. The accounting estimates that require our most significant, difficult and subjective judgments include the valuation of marketable equity securities; the valuation allowance for accounts receivable, notes receivable and inventory and the assessment of recoverability of long-lived assets and intangible assets and the recognition and measurement of current and deferred income taxes (including the measurement of uncertain tax positions). Actual results could differ materially from our estimates.

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 \$0.9 and \$2.7 million at financial institutions in excess of governmentally insured limits at December 31, 2008 and 2007.

TALON INTERNATIONAL, INC.
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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 3 to the consolidated financial statements.

ALLOWANCE FOR ACCOUNTS AND NOTES RECEIVABLE DOUBTFUL ACCOUNTS

We are required to make judgments as to the collectability of accounts and notes receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts and notes receivable that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables or note receivable to their net realizable value. 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. The total allowance for accounts receivable doubtful accounts at December 31, 2008 and 2007 was \$217,300 and \$140,500, respectively, and for notes receivable at December 2008 was \$474,000. See Note 4 to 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, | |
|--|-------------------------|---------------|
| | ----- 2008 ----- | 2007 ----- |
| Finished goods | \$2,880,319 | \$3,506,439 |
| Less inventory valuation reserves | 1,211,170 | 1,019,012 |

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| | | |
|-------------------------|-------------------------------|-------------------------------|
| Total inventories | ----- \$1,669,149 ===== | ----- \$2,487,427 ===== |
|-------------------------|-------------------------------|-------------------------------|

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. See Note 5.

TALON INTERNATIONAL, INC.
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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 | 1 year |
| Idle equipment | 5 to 10 years |

Property and equipment consist of the following:

| | Year Ended December 31, | |
|-------------------------------|-------------------------|------------------------|
| | ----- 2008 ----- | ----- 2007 ----- |
| Furniture and fixtures | \$ 613,924 | \$ 600,491 |
| Machinery and equipment | 365,951 | 1,694,921 |
| Computer equipment | 3,654,766 | 4,137,834 |

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| | | |
|---|--------------|--------------|
| Leasehold improvements | 332,270 | 248,129 |
| Dies and molds | 106,273 | 106,273 |
| Idle equipment | -- | 4,198,880 |
| | ----- | ----- |
| | 5,073,183 | 10,986,528 |
| Accumulated depreciation and amortization | 2,988,939 | 5,776,082 |
| | ----- | ----- |
| Net property and equipment | \$ 2,084,244 | \$ 5,210,446 |
| | ===== | ===== |

Depreciation expense for the years ended December 31, 2008, 2007 and 2006 was \$1,079,000, \$1,136,000 and \$1,090,000, respectively.

Fixed Assets held for sale at December 31, 2008 of \$407,655 consists of idle equipment which is principally machinery and equipment used for the production of zipper chain and the assembly of finished zippers. Fixed Assets held for sale at December 31, 2007 of \$700,000 consists of the North Carolina land and manufacturing facility that was closed in connection with the Company's 2005 restructuring plan. This property was sold on October 22, 2008 for \$725,000 and the related mortgage note against the property was paid in full. See Note 5.

TALON INTERNATIONAL, INC.
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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, 2008, the Company evaluated its Intangible Assets and determined that there was no impairment of these assets and made no changes to the net carrying amount of Tradename for the years ended December 31, 2008 and 2007. Amortization expense related to exclusive license and intellectual property rights of \$29,000 and \$115,500 were recorded for the years ended December 31, 2007 and 2006, respectively. During the first quarter of 2007, the exclusive license and intellectual property became fully amortized, thus no amortization expense for intangible assets was recorded for December 31, 2008.

Other intangible assets as of December 31, 2008 and 2007 are as follows:

| | | |
|--|-------------------------|------|
| | Year Ended December 31, | |
| | ----- | |
| | 2008 | 2007 |
| | ----- | |

Intangible Assets:

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| | | |
|--|--------------|--------------|
| Tradename | \$ 4,110,751 | \$ 4,110,751 |
| Accumulated amortization | -- | -- |
| | ----- | ----- |
| Tradename, net | 4,110,751 | 4,110,751 |
| Exclusive license and intellectual property rights | 577,500 | 577,500 |
| Accumulated amortization | (577,500) | (577,500) |
| | ----- | ----- |
| Exclusive license and intellectual property rights, net | 0 | 0 |
| | ----- | ----- |
| Intangible assets, net | \$ 4,110,751 | \$ 4,110,751 |
| | ===== | ===== |

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

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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

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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. See Note 13.

STOCK-BASED COMPENSATION

We have employee equity incentive plans, which are described more fully in Note 11. Effective 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. Accordingly, we measure share-based compensation at the grant date based on the fair value of the award.

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, 2007 and 2008 reflect the impact of SFAS 123(R).

Options issued to consultants, which are more fully described in Note 11, 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."

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, 2008, 2007 and 2006 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 2008, 2007 and 2006 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, 2008, 2007 and 2006, expected forfeitures are immaterial and as such the Company is recognizing forfeitures as they occur.

The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant uses the Black-Scholes model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are

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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.

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.

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 years ended December 31, 2008 and 2007 are unrealized gains in foreign currency translation of \$99,737 and \$44,444, respectively. The foreign currency translation adjustment represents the net currency translation adjustment gains and losses related to our China and India subsidiaries.

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 2008 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

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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.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

INTEREST EXPENSE AND INTEREST INCOME - Interest expense reflects the cost of borrowing and amortization of deferred financing costs and discounts. Interest expense for the years ended December 31, 2008, 2007 and 2006 was \$2,501,000 \$1,922,000 and \$1,357,000, respectively. Interest income of \$64,000, \$242,000 and \$368,000 for the years ended December 31, 2008, 2007 and 2006, 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 goods sold.

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. See Note 14.

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.

NEW ACCOUNTING PRONOUNCEMENTS

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In December 2008, FASB issues FASB Staff Position (FSP) 140-4 and FIN 46(R)-8, Disclosures by Public Entities about Transfers of Financial Assets and Interests in Variable Interest Entities. The purpose of this FSP is to promptly increase disclosures by public entities and enterprises until the pending amendments to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, (FAS 140) and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, (FIN 46(R)) are finalized and approved by the FASB. The FSP is effective for reporting periods (interim and annual) ending after December 15, 2008. We adopted this FSP for our year ended December 31, 2008 and the adoption did not have any impact on our consolidated financial statements.

On May 9, 2008, FASB issued FASB Staff Position No. APB 14-1 "Accounting for Convertible Debt Instruments That May Be Turned Into Cash Upon Conversion" ("APB 14-1"). APB 14-1 addresses that convertible debt instruments may be settled in cash upon conversion (including partial cash settlement). Additionally, APB 14-1 specifies that issuers of such instruments should

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. APB 14-1 is to be applied retrospectively for the first annual reporting on or after December 15, 2008 and interim periods within the fiscal year. Early adoption is not permitted. We do not believe No. APB 14-1 will have a material impact on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411. We do not believe SFAS 162 will have any impact on our consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, DISCLOSURES ABOUT DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES - AN AMENDMENT OF FASB STATEMENT NO. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We do not believe SFAS 161 will have a material impact on our consolidated financial statements.

In February 2008, the FASB issued FASB Staff Position 157-2, Effective Date of FASB Statement No. 157 which delays the effective date of SFAS No. 157 to January 1, 2009, for the Company, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We believe the adoption of the delayed items of SFAS No. 157 will not have a

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material impact on our consolidated financial statements.

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 acquirer 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.

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TALON INTERNATIONAL, INC. NOTES TO 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 have adopted SFAS 159 in the first quarter of 2008. We chose to not report unrealized gains and losses in earnings. See Note 3.

NOTE 2-- SIGNIFICANT RISKS AND UNCERTAINTIES

Our consolidated financial statements have been prepared on a going concern basis of accounting which contemplates the continuity of operations and the realization of assets, liabilities and commitments in the normal course of business. During fiscal years 2008 and 2007, the Company experienced losses from operations and has an accumulated deficit as of December 31, 2008 of \$63,651,000. As of December 31, 2008, the Company was also in default with the covenants in the Revolving Credit and Term Loan Agreement with CVC California, LLC ("CVC") and was required to pay a fee to have the lender waive this covenant at December 31, 2008. Additionally, the Company anticipates that it will be in default of the covenants at March 31, 2009, and it has also paid a waiver fee to the lender for this period. It is uncertain whether we will be in compliance with the financial covenants in future quarters. See Subsequent Event Note 19 to our consolidated financial statements. Our consolidated financial statements do not reflect any adjustments relating to the recoverability and classification of

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recorded asset amounts or classification of liabilities that would be required if a default occurred and we were unable to obtain a waiver or modify the covenants. Should we fail to be in compliance with these covenants for three successive quarters and we are unable to obtain a waiver or amend these covenants, we may be unable to continue as a going concern.

Our performance is subject to worldwide economic conditions and their impact on levels of consumer spending that affect not only the ultimate consumer, but also retailers, which constitute many of our largest customers. Consumer spending recently has deteriorated significantly and may remain depressed, or be subject to further deterioration for the foreseeable future. The worldwide apparel industry is heavily influenced by general economic cycles. Purchases of fashion apparel and accessories tend to decline in periods of recession or uncertainty regarding future economic prospects, as disposable income declines. Many factors affect the level of consumer spending in the apparel industries, including, among others: prevailing economic conditions, levels of employment, salaries and wage rates, energy costs, interest rates, the availability of consumer credit, taxation and consumer confidence in future economic conditions. During periods of recession or economic uncertainty, we may not be able to maintain or increase our sales to existing customers, make sales to new customers, or maintain our earnings from operations as a percentage of net sales. As a result, our operating results may be adversely and materially affected by sustained or further downward trends in the United States or global economy. The Company's ability to continue as a going concern is dependent on its ability to generate sufficient cash flow to meet its obligations on a timely basis, to obtain additional financing as may be required and ultimately to attain profitable operations.

In response to these conditions, the Company has taken steps to significantly reduce its operating costs, eliminate employees in response to lower volumes, curtail capital and discretionary spending to better align the Company's organizational and cost structures with future Company and industry expectations and uncertainties and to insure the company will have sufficient cash flow to cover its operating needs. The Company has also implemented programs to increase sales incentives, to secure preferred supplier status with customers and to accelerate cash collections from customers. There can be no assurance; however, that the Company will be successful in these matters or that these steps will be sufficient to ensure the Company can continue as a going concern.

NOTE 3-- MARKETABLE SECURITIES AND RELATED 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 receivable in monthly installments over thirty-one months beginning March 1, 2006. The payments, after initial period generally ranged from \$133,000-\$267,000 per month until paid in full, but no later than July 1, 2008.

TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Azteca failed to make the scheduled note payments due on July 1, 2007 and all subsequent periods thereafter, triggering a default, resulting in the entire note balance becoming immediately due and payable. On September 10, 2007, after meeting with and conducting extensive discussions with Azteca, they failed to provide to the Company certain security interests as required under the note

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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 note balance from Azteca. In December 2007, an agreement was reached whereby Azteca delivered shares of common stock of a separate public corporation in lieu of the note receivable and the Company reversed a portion of the impairment recorded in September 2007 and reflected income of \$1,040,000 as a reversal of the previously recorded bad debt. The agreement with Azteca called for them to deliver 2,000,000 shares of unrestricted common stock of a separate public corporation with a value of \$1,040,000, in exchange for cancellation of the Azteca note receivable. No realized or unrealized gains or losses were recognized during the year ended December 31, 2007. On January 30, 2008, the Company received the unrestricted common stock of this public company and the Company could begin trading these shares, selling no more than 10,000 shares per week in the open market, and without restriction in private transactions.

On September 30, 2008, this public company issued its second quarter 2008 SEC filing stating it had no customers, cash flow, or new orders and that it was in violation of its financial covenants to its lender. The Company has concluded that the asset is permanently impaired and as a result, recognized a valuation reserve for the full value of the investment of \$1,040,000 at September 30, 2008.

NOTE 4-- NOTE RECEIVABLE RELATED PARTY

Due from related parties at December 31, 2008 and 2007 includes \$674,010 and \$625,454, respectively, of unsecured notes, advances and accrued interest receivable from Colin Dyne, a director and stockholder of the Company. The economic decline in the fourth quarter of 2008 and an expected payment in 2008 that was not received, impacted the time and risk of full collection of this note, and as a result, the Company recorded an impairment charge of \$474,010 against this note at December 31, 2008.

NOTE 5-- FIXED ASSETS HELD FOR SALE

The Company has equipment for 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 those operations in 2005. The Company relocated this equipment to Asia and negotiated with manufacturing partners for the redeployment of this equipment in joint manufacturing agreements. China importation fees, regulations and operating use restrictions however made this arrangement uneconomical. Accordingly, the Company modified its negotiations to affect a sale of the equipment with certain use rights. The Company is now in negotiations to potentially sell this equipment to a third party. The decision to sell the equipment as compared to redeploying it in operations, modified the cash returns available from the assets. Accordingly, the Company analyzed the cash flow of the potential sales value and determined that it was likely that the sale of this equipment would not recover its carrying value. As a result, the Company has recorded an impairment charge of \$2,026,000 for the difference from the estimated sales value of the equipment and the previous carrying value. The adjusted carrying value of the equipment at December 31, 2008 is \$350,000.

The Company also determined that certain components of its Tekfit equipment, which is used in the manufacture of the Tekfit proprietary stretch waistband, will not be redeployed as a consequence of lower demand for this product and the affect of the current economic crisis on the apparel industry. As a result the Company recorded an impairment charge of \$403,500 for the equipment which will not be utilized in foreseeable operations. The adjusted carrying value of the equipment at December 31, 2008 is \$58,000.

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Property held for sale at December 31, 2007 of \$700,000 consists of the North Carolina land and manufacturing facility that was closed in connection with the Company's 2005 restructuring plan. This property was sold on October 22, 2008 for \$725,000 and the related mortgage note against the property was paid in full.

NOTE 6-- DEMAND NOTES PAYABLE TO RELATED PARTIES

Demand notes payable to related parties consist of two notes payable issued from 1995-1998 to parties related to or affiliated with directors of the Company with interest rates of 10% per annum, due and payable on the fifteenth day following delivery of written demand for payment. The outstanding amounts of these notes payable as of December 31, 2008 and 2007 were \$222,264 and \$213,100, respectively.

Interest expense, interest accrual and interest amount paid related to the demand notes payable to related parties for the years ended December 31, 2008, 2007 and 2006 are as follows:

| | YEAR ENDED DECEMBER 31, | | |
|--------------------------------|-------------------------|-----------|-----------|
| | 2008 | 2007 | 2006 |
| Interest expense | \$ 9,173 | \$ 30,568 | \$ 67,753 |
| Accrued interest balance | \$137,088 | \$127,915 | \$515,738 |
| Interest paid | \$ -- | \$518,546 | \$ -- |

NOTE 7-- CAPITAL LEASE OBLIGATIONS

The Company financed equipment purchases through various capital lease obligations expiring through February 2010. These obligations bear interest at various rates ranging from 6.6% to 12.2% per annum. Future minimum annual payments under these capital lease obligations are as follows:

| YEARS ENDING DECEMBER 31, | Amount |
|---|------------|
| 2009 | \$ 190,913 |
| 2010 | 1,947 |
| 2011 and thereafter | -- |
| Total payments | 192,860 |
| Less amount representing interest | (8,506) |
| Balance at December 31, 2008 | 184,354 |
| Less current portion | 182,444 |
| Long-term portion | \$ 1,910 |

At December 31, 2008, total property and equipment under capital lease

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obligations and related accumulated depreciation was \$840,914 and \$479,742, respectively. At December 31, 2007, total property and equipment under capital lease obligations and related accumulated depreciation was \$1,723,283 and \$666,483, respectively.

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TALON INTERNATIONAL, INC.
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NOTE 8-- NOTES PAYABLE

Notes payable consist of the following:

| | Year Ended December 31, | |
|---|-------------------------|------------|
| | 2008 | 2007 |
| <p>\$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; paid in full in October 2008</p> | \$ -- | \$ 689,651 |
| <p>\$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; note payments were accelerated in October 2008 changing the monthly payments to \$25,000 and the unpaid principal and interest due from November 22, 2009 to June 30, 2009; secured by manufacturing equipment</p> | 144,064 | 371,863 |
| <p>\$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</p> | -- | 86,078 |
| <p>Notes Payable</p> | 144,064 | 1,147,592 |
| <p>Less Current portion</p> | 144,064 | 299,108 |
| <p>Notes payable, net of current portion</p> | \$ - | \$ 848,484 |

Future minimum annual payments including interest under these notes payable obligations are as follows:

| YEARS ENDING DECEMBER 31, | Amount |
|---------------------------|------------|
| 2009 | \$ 146,709 |

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| | |
|---------------------------|------------|
| 2010 and thereafter | -- |
| | ----- |
| Total | \$ 146,709 |
| | ===== |

NOTE 9 - DEBT FACILITY

On June 27, 2007, the Company entered into a Revolving Credit and Term Loan Agreement with Bluefin Capital, LLC subsequently assigned to CVC California, 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 permitted borrowings based upon a formula including 75% the Company's eligible receivables and 55% of eligible inventory, and provided for monthly interest payments at the prime rate (5.25% at December 31, 2008) 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.

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 warrants to purchase 2,100,000 shares of common stock. The warrants were exercisable over a five-year period and initially 700,000 warrants were exercisable at \$0.95 per share; 700,000 warrants were exercisable at \$1.05

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per share; and 700,000 warrants were exercisable at \$1.14 per share. The warrants did not require cash settlements. The relative fair value of the equity (\$2,374,169, which includes a reduction for financing costs) issued with this debt facility was allocated to paid-in-capital and reflected as a debt discount to the face value of the term note. This discount is being 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 as a reduction to the face value of the note on the balance sheet.

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

On April 3, 2008, the Company executed a further amendment to its existing loan agreement. The amendment included a redefining of the EBITDA covenants, and the cancellation of the common stock warrants previously issued to the lender in exchange for the issuance by the Company of an additional note

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payable to CVC for \$1.0 million. The note bears interest at 8.5% and both the note and accrued interest are payable at maturity on June 30, 2010. In addition, the Company's borrowing base was modified in this amendment by increasing the allowable portion of inventory held by third party vendors to \$1.0 million with no more than \$500,000 held at any one vendor and increasing the percentage of accounts receivable to be included in the borrowing base to 85%. The Company incurred a one-time modification fee of \$145,000 to secure the amendment of the agreement. The new relative fair value of the equity issued with this debt of \$2,542,000, including the modifications in this amendment and a reduction for financing costs, is being amortized over the term of the note.

In connection with this amendment the Company evaluated the debt amendment under EITF 96-19 "Debtor's Accounting for a Modification or Exchange or Debt Instruments". It was determined that the debt modification did not constitute a material change as defined by EITF 96-19 and did not qualify for treatment as a troubled debt restructuring. Accordingly, the Company recorded a reduction to equity and an increase to notes payable for the fair value of the warrants of \$260,205 and the difference (\$739,795) between the fair value of the warrants at the time of repurchase and the face value of the note has been recorded as an additional deferred cost and is reflected as a reduction to the face value of the note on the balance sheet. This cost is being amortized using the interest-method over the life of the modified notes and is reflected as interest expense.

Under the terms of the credit agreement, as amended, the Company is required to meet certain coverage ratios, among other restrictions, including a restriction from declaring or paying a dividend prior to repayment of all the obligations. The financial covenants, as amended, require that the Company maintain at the end of each fiscal quarter "EBITDA" (as defined in the agreement) in excess of the principal and interest payments for the same period of not less than \$1.00 and in excess of ratios set out in the agreement for each quarter. The Company failed to satisfy the minimum EBITDA requirement for quarter ended December 31, 2008, and a waiver fee of 1% of the debt commitment was accrued and the requirement delayed to the next quarter. If two consecutive quarters fail to meet the minimum EBITDA, the waiver fee increases to 2%. If three consecutive quarters fail to meet the minimum EBITDA, or the Company does not pay the waiver fee, the credit agreement would be in default and the lender may demand immediate repayment of the full amount of the notes outstanding, which if we were unable to obtain a waiver or amend these covenants, we may be unable to continue as a going concern, see Note 2. See Note 19 for subsequent event regarding waiver and amendment of loan covenants.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2008, the Company had outstanding borrowings of \$10,375,000 under the term notes (discounted carrying value of \$8,067,428) and \$4,639,000 under the revolving credit note.

At the initial closing of the agreement 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,

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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.

Interest expense related to the Revolving Credit and Term Loan Agreement for the year ended December 31, 2008 was \$2,370,570, which includes \$1,186,837 in amortization of discounts and deferred financing costs. 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 10--STOCKHOLDERS' EQUITY AND 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

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 14).

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NOTE 11--STOCK OPTION INCENTIVE PLAN AND WARRANTS

STOCK OPTION INCENTIVE PLAN

On July 14, 2008, at the Company's annual meeting of stockholders, a new 2008 Stock Plan was approved by the stockholders. The 2008 Stock Plan authorizes up to 2,500,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. On July 31, 2007, at the Company's annual meeting of stockholders, the 2007 Stock Plan was approved which replaced the 1997 Stock Plan. The 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. Options granted to certain employees in 2008 include certain acceleration features based on Company performance as determined the Board of Directors each year. Consistent with SFAS 123(R), the stock based compensation expense for the employee options are recognized on a time-phased vesting schedule through the vesting date of December 31, 2010. In calculating the outcome of meeting performance conditions, the Company did not meet performance criteria and accordingly, the Company did not use accelerated vesting for these options.

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 following 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.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

| EMPLOYEES AND DIRECTORS | Number of Shares ----- | Weighted Average Exercise Price ----- |
|---|------------------------------|---|
| Options outstanding - January 1, 2006 | 1,833,000 | \$ 3.46 |
| Granted | 3,546,135 | \$ 0.32 |
| Canceled | (301,500) | \$ 3.56 |

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| | | |
|---|-----------|---------|
| Options outstanding - December 31, 2006 | 5,077,635 | \$ 1.41 |
| Granted | 46,600 | \$ 1.02 |
| Exercised | (75,000) | \$ 0.57 |
| Canceled | (376,000) | \$ 0.76 |
| Options outstanding - December 31, 2007 | 4,673,235 | \$ 1.46 |
| Granted | 2,960,000 | \$ 0.21 |
| Canceled | (532,699) | \$ 0.69 |
| Options outstanding - December 31, 2008 | 7,100,536 | \$ 0.98 |

The aggregate intrinsic value of stock options exercised during 2007 was \$72,000, which is the difference between the exercise price of the stock versus the quoted price of our common stock on the date the options were exercised. There were no stock options exercised in 2008 and 2006.

The Company has also issued certain warrants and options to non-employees. The following table summarizes all options issued to Non-Employees:

| NON-EMPLOYEES | Number of Shares | Weighted Average Exercise Price |
|---|------------------|---------------------------------|
| Options & warrants outstanding - January 1, 2006 | 1,377,147 | \$ 4.36 |
| Canceled | (133,334) | \$ 4.54 |
| Options & warrants outstanding - December 31, 2006 .. | 1,243,813 | \$ 4.13 |
| Granted | 2,100,000 | \$ 0.75 |
| Canceled | (180,000) | \$ 3.63 |
| Options & warrants outstanding - December 31, 2007 .. | 3,163,813 | \$ 1.97 |
| Canceled | (2,845,318) | \$ 0.55 |
| Options & warrants outstanding - December 31, 2008 .. | 318,495 | \$ 3.65 |

The Company's determination of fair value of share-based payment awards on the date of grant uses the Black-Scholes model and the assumptions noted in the following table for the years ended December 31. Expected volatilities are based on the historical volatility of the Company's stock price and other factors. These variables include, but are not limited to, the expected stock price volatility over the expected term of the awards and actual and projected employee stock option exercise behaviors. The expected option term is estimated using the "safe harbor" provisions under SAB 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.

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| | 2008 | 2007 | 2006 |
|------------------------------|---------|---------|---------|
| Expected volatility | 95% | 64% | 65% |
| Expected term in years | 6.1 yrs | 6.1 yrs | 6.1 yrs |
| Expected dividends | -- | -- | -- |
| Risk-free rate | 3.5% | 4.8% | 4.5% |

A summary of our stock option information under all Stock Plans as of December 31, 2008 is as follows:

| EMPLOYEE AND DIRECTOR | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Intrinsic Value |
|--|------------------|---------------------------------|---|-----------------|
| Outstanding at December 31, 2008 | 7,100,536 | \$ 0.98 | 6.0 | \$ |
| Vested and Expected to Vest | 6,733,009 | \$ 1.02 | 5.75 | \$ |
| Exercisable | 4,305,253 | \$ 1.46 | 4.08 | \$ |

| NON-EMPLOYEE OPTIONS & WARRANTS | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Intrinsic Value |
|--|------------------|---------------------------------|---|-----------------|
| Outstanding at December 31, 2008 | 318,495 | \$ 3.65 | 0.9 | \$ 0 |
| Vested and Expected to Vest | 318,495 | \$ 3.65 | 0.9 | \$ 0 |
| Exercisable | 318,495 | \$ 3.65 | 0.9 | \$ 0 |

The aggregate intrinsic value of the stock options is calculated as the difference between the exercise price of a stock option and the quoted price of our common stock at December 31, 2008. It excludes stock options that have exercise prices in excess of the quoted price of our common stock at December 31, 2008.

There was \$492,000 of total unrecognized compensation costs related to non-vested stock options and warrants as of December 31, 2008. 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, 2008, 2007 and 2006 was \$407,000, \$245,000 and \$236,000, respectively.

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

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respectively, for issuance pursuant to awards granted to individuals under the plan.

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TALON INTERNATIONAL, INC.
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NOTE 12--INCOME (LOSS) PER SHARE

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

| Years ended: | December 31, 2008 | | | December 31, 2007 | |
|---|---------------------|-------------------------|---------------------|-----------------------|-------------------------|
| | Loss (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Income (Denominator) |
| Basic income (loss): | | | | | |
| Income (loss) available to common stockholders | \$ (8,358,786) | 20,291,433 | \$ (0.41) | \$ (4,921,707) | 20,291,433 |
| Effect of dilutive securities: | | | | | |
| Options | -- | -- | -- | -- | -- |
| Warrants | -- | -- | -- | -- | -- |
| Income (loss) available to common stockholders | \$ (8,358,786) | 20,291,433 | \$ (0.41) | \$ (4,921,707) | 20,291,433 |

| Years ended: | December 31, 2006 | | | December 31, 2005 | |
|---|---------------------|-------------------------|---------------------|-----------------------|-------------------------|
| | Loss (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Income (Denominator) |
| Basic income (loss): | | | | | |
| Income (loss) available to common stockholders | \$ 309,303 | 18,377,484 | \$ 0.02 | \$ 309,303 | 18,377,484 |
| Effect of dilutive securities: | | | | | |
| Options | -- | 578,312 | 0.00 | -- | -- |
| Warrants | -- | -- | -- | -- | -- |
| Income (loss) available to common stockholders | \$ 309,303 | 18,955,796 | \$ 0.02 | \$ 309,303 | 18,955,796 |

Warrants to purchase 318,495 shares of common stock for \$3.65 and options to purchase 7,100,536 shares of common stock for between \$0.18 and

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\$5.23, per share were outstanding for the year ended December 31, 2008, 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 3,163,813 shares for common stock for 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 for common stock for 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.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13--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, | | |
|---------------|-------------------------|-----------|-----------|
| | 2008 | 2007 | 2006 |
| | ----- | ----- | ----- |
| Current: | | | |
| Federal | \$ 3,754 | \$ 40,030 | \$ 29,900 |
| State | 15,306 | 4,559 | 4,000 |
| Foreign | 51,539 | 134,442 | -- |
| | ----- | ----- | ----- |
| | 70,599 | 179,031 | 33,900 |
| Deferred: | | | |
| Federal | 40,030 | (40,030) | -- |
| State | 1,059 | (1,059) | -- |
| Foreign | (151,460) | (66,993) | -- |
| | ----- | ----- | ----- |
| | (110,371) | (108,082) | -- |
| | ----- | ----- | ----- |
| | \$ (39,772) | \$ 70,949 | \$ 33,900 |
| | ===== | ===== | ===== |

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

| | Year Ended December 31, | | |
|----------|-------------------------|-------|-------|
| | 2008 | 2007 | 2006 |
| | ----- | ----- | ----- |
| Current: | | | |

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| | | | |
|--|--------|--------|--------|
| Federal statutory rate | 34.0% | 34.0% | 34.0% |
| State taxes net of federal benefit | (0.1) | (1.6) | 2.3 |
| Income earned from foreign subsidiaries | (2.6) | (54.9) | 18.7 |
| Net operating loss valuation allowance . | (33.4) | (18.4) | (71.7) |
| Change in effective state tax rate | -- | 0.1 | 22.4 |
| Other | 2.6 | 39.3 | 4.2 |
| | ----- | ----- | ----- |
| | 0.5% | (1.5)% | 9.9% |
| | ===== | ===== | ===== |

Income (loss) before income taxes is as follows:

| | Year Ended December 31, | | |
|----------------|-------------------------|-----------------|----------------|
| | 2008 | 2007 | 2006 |
| | ----- | ----- | ----- |
| Domestic | \$ (6,844,884) | \$ (11,827,832) | \$ (1,341,475) |
| Foreign | (1,513,902) | 6,977,074 | 1,684,678 |
| | ----- | ----- | ----- |
| | \$ (8,358,786) | \$ (4,850,758) | \$ 343,203 |
| | ===== | ===== | ===== |

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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, | |
|---|-------------------------|---------------|
| | 2008 | 2007 |
| | ----- | ----- |
| Net deferred tax asset: | | |
| Net operating loss carry-forward | \$ 22,122,386 | \$ 20,289,672 |
| Depreciation and amortization (liability) | 82,623 | (899,776) |
| Bad Debt and note receivable allowance .. | 195,933 | 42,065 |
| Marketable security impairment | 399,038 | -- |
| Related part interest | 155,210 | 200,093 |
| Inventory allowance | 171,496 | 265,200 |
| Credit carryforwards | 95,221 | 41,089 |
| Other | 465,048 | 332,420 |
| | ----- | ----- |
| | 23,686,955 | 20,270,763 |
| Less: Valuation allowance | (23,468,657) | (20,162,681) |
| | ----- | ----- |
| | \$ 218,298 | \$ 108,082 |
| | ===== | ===== |

On January 1, 2007 the Company adopted the provisions of Financial Accounting Standard Board Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109". FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and

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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:

| | Year Ended December 31, | |
|------------------------------|-------------------------|-----------|
| | 2008 | 2007 |
| Beginning Balance | \$258,000 | \$246,000 |
| Interest and penalties | 16,000 | 12,000 |
| | \$274,000 | \$258,000 |
| | ===== | ===== |

At December 31, 2008 and 2007, Talon International, Inc. had Federal net operating loss carry-forwards (or "NOLs") of approximately \$60.2 million and \$55.9 million, respectively and state NOLs of \$24.0 million and \$18.1 million respectively. The Federal NOL is available to offset future taxable income through 2026, and the state NOL expires in 2016. 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. The Company had a limitation due to Section 382 during 2004 to 2006; however, as of December 31, 2008 we have no limitation. Thus, the limitation has had no impact on our NOL carry-forwards.

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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

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income is expected in future years in order to utilize the deferred tax asset.

In 2008 and 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 domestic deferred tax assets in future year with the exception of the alternative minimum tax credit carry-forward of \$41,089 in 2007. Accordingly, at December 31, 2008 and 2007 the Company has recorded a valuation allowance of \$23.5 and \$20.2 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.

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, dependent upon events that may or may not occur and because the impact of recording a valuation allowance may be material to the assets reported on its balance sheet and results of operations.

In 2007, the Company included in its consolidated U.S. federal tax return as a deemed dividend, \$4.6 million or all of the undistributed earnings of its foreign subsidiaries as a result of the loan agreement with CVC. See Note 9. At December 31, 2008 undistributed earnings from its foreign subsidiaries are \$0.0.

NOTE 14--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 2013. 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 statement of operations on a straight-line basis over the related lease term.

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NOTES TO
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The future minimum lease commitments at December 31, 2008 are as follows:

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| Years Ending December 31, | Amount |
|-----------------------------|------------|
| 2009..... | \$ 570,300 |
| 2010..... | 280,500 |
| 2011..... | 19,600 |
| 2012 and after..... | 7,800 |
| | ----- |
| Total minimum payments..... | \$ 878,200 |
| | ===== |

Total rental expense for the years ended December 31, 2008, 2007 and 2006 aggregated \$813,373, \$591,312 and \$640,864, 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, 2008, 2007 and 2006 amounted to \$24,061, \$25,494, \$22,276, respectively.

CONTINGENCIES

On October 12, 2005, a shareholder class action complaint was filed in the United States District Court for the Central District of California ("District Court") against the Company, Colin Dyne, Mark Dyne, Ronda Ferguson and August F. Deluca (collectively, the "Individual Defendants" and, together with the Company, "Defendants"). The action is styled HUBERMAN V. TAG-IT PACIFIC, INC., ET AL., Case No. CV05-7352 R(Ex). On January 23, 2006, the District Court heard competing motions for appointment of lead plaintiff. The District Court appointed Seth Huberman as the lead plaintiff ("Plaintiff"). On March 13, 2006, Plaintiff filed an amended complaint. Plaintiff's amended complaint alleged that defendants made false and misleading statements about the Company's financial situation and the Company's relationship with certain of the Company's 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. The amended complaint purports to state claims under Section 10(b)/Rule 10b-5 and Section 20(a) of the Securities Exchange Act of 1934. On August 21, 2006, Defendants filed their answer to the amended complaint, denying the material allegations of wrongdoing. On February 20, 2007, the District Court denied class certification. On April 2, 2007, the District 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 with the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit"), and his opening appellate brief was filed on October 15, 2007. Defendants' brief was filed on November 28, 2007. The Ninth Circuit held oral arguments on October 23, 2008. On January 16, 2009, the Ninth Circuit issued an unpublished memorandum, instructing the District Court to certify a class, reversing the District Court's grant of summary judgment, and remanding for further proceedings consistent with its decision. The District Court has scheduled a status conference for May 4, 2009. The Company intends to vigorously defend this lawsuit; however, the outcome of this lawsuit or an estimate of the potential 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, the Company filed suit against Pro-Fit Holdings, Limited in the U.S. District Court for the Central District of California - Tag-It Pacific, Inc. v. Pro-Fit Holdings, Limited, CV 04-2694 LGB (RCx) -- asserting various contractual and tort claims relating to the Company's

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exclusive license and intellectual property agreement with Pro-Fit, seeking declaratory relief, injunctive relief and damages. It is the Company's position that the agreement with Pro-Fit gives the Company exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. On June 5, 2006, the Court denied the Company's motion for partial summary judgment, but did not find that the Company breached the agreement with Pro-Fit and a trial is

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

required to determine issues concerning the Company's 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 Company also filed a second civil action against Pro-Fit and related companies in the California Superior Court which was removed to the United States District Court, Central District of California. In April 2008, Pro-Fit and certain related companies were placed into administration in the United Kingdom. On May 21, 2008, the joint administrators for Pro-Fit and its related companies filed petitions under Chapter 15 of Title 11 of the United States Code for Pro-Fit and two related companies in the United States Bankruptcy Court for the Central District of California seeking recognition of the United Kingdom administration proceedings and related relief. As a consequence of the chapter 15 filings by the joint administrators, all litigation by the Company against Pro-Fit has been stayed. The Company has derived a significant amount of revenue from the sale of products incorporating the stretch waistband technology in the past and the Company's 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 the Company. Additionally, the Company has incurred significant legal fees in this litigation, and unless the case is settled or resolved, may continue to incur additional legal fees in order to assert its rights and claims against Pro-Fit and any successor to those assets of Pro-Fit that are subject to the Company's exclusive license and intellectual property agreement with Pro-Fit and to defend against any counterclaims.

The Company currently has pending a number of other claims, suits and complaints that arise in the ordinary course of the Company's business. The Company believes that it has meritorious defenses to these claims and that the claims are either covered by insurance or, after taking into account the insurance in place, would not have a material effect on the Company's consolidated financial 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 - an 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 No. 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

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insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws is minimal and therefore, the Company has not recorded any related liabilities.

The Company enters into indemnification provisions under its agreements with investors and its agreements with other parties in the normal course of business, typically with suppliers, customers and landlords. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by the Company with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15--SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

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

| | Twelve Months Ended December 31, 2008 | | | |
|----------------------|--|------------------------|--------------------------|--------------------------------|
| | ----- Talon ----- | ----- Trim ----- | ----- Tekfit ----- | ----- Consolidated ----- |
| Net sales | \$ 28,428,885 | \$ 19,537,302 | \$ 204,793 | \$ 48,170,980 |
| Cost of goods sold . | 22,783,691 | 12,666,844 | 103,056 | 35,553,591 |
| Gross profit (loss) | 5,845,193 | 6,870,458 | 101,737 | 12,617,389 |
| Operating expenses* | | | | 18,579,006 |
| Loss from operations | | | | \$ (5,961,617) ===== |

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| | Twelve Months Ended December 31, 2007 | | | |
|----------------------|--|---------------|------------|----------------|
| | Talon | Trim | Tekfit | Consolidated |
| Net sales | \$ 21,159,595 | \$ 18,688,698 | \$ 681,262 | \$ 40,529,555 |
| Cost of goods sold . | 15,711,171 | 12,190,803 | 520,846 | 28,422,820 |
| Gross profit (loss) | 5,448,423 | 6,497,895 | 160,416 | 12,106,735 |
| Operating expenses* | | | | 15,277,414 |
| Loss from operations | | | | \$ (3,170,679) |

*Operating expenses are not segregated by division and includes impairment reserve losses.

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CONSOLIDATED FINANCIAL STATEMENTS

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

| | Year Ended December 31, | | |
|--------------------------|-------------------------|--------------|--------------|
| | 2008 | 2007 | 2006 |
| Sales: | | | |
| United States | \$ 3,332,257 | \$ 3,692,468 | \$ 4,223,052 |
| Hong Kong | 15,181,280 | 14,178,421 | 13,650,419 |
| Dominican Republic | 202,529 | 700,868 | 8,966,828 |
| China | 13,614,709 | 11,159,726 | 6,063,416 |
| India | 2,536,929 | 2,187,684 | 1,205,486 |
| Bangladesh | 2,434,382 | 1,924,943 | 2,070,349 |
| Mexico | 610,983 | 783,762 | 2,476,313 |
| Other | 10,257,911 | 5,901,683 | 10,169,139 |
| Total | \$48,170,980 | \$40,529,555 | \$48,825,002 |
| Long-lived Assets: | | | |
| United States | \$ 4,955,725 | \$ 8,778,381 | \$ 9,529,932 |
| Hong Kong | 989,761 | 556,864 | 336,149 |
| Dominican Republic | -- | 558,198 | 667,238 |
| Mexico | -- | 1,072 | 5,198 |
| China | 243,905 | 109,770 | 49,488 |
| Other | 5,604 | 16,912 | 3,315 |
| Total | \$ 6,194,995 | \$10,021,197 | \$10,591,320 |

NOTE 16--MAJOR CUSTOMERS AND VENDORS

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For the years ended December 31, 2008, 2007 and 2006, the Company's three largest customers represented approximately 8%, 9% and 18%, respectively, 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.

Five vendors, each representing more than 6% of the Company's purchases, accounted for approximately 46% of the Company's purchases for the year ended December 31, 2008. 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 years ended December 31, 2008 and 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.

Included in accounts payable and accrued expenses at December 31, 2008 and 2007 is \$3,593,552 and \$2,239,000 due to these vendors.

NOTE 17--RELATED PARTY TRANSACTIONS

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 2008 and 2007 the Company had sales of \$88,000 and \$241,000, respectively, to Versatile Entertainment. Accounts receivable of \$18,000 and \$44,000 were outstanding from Versatile Entertainment at December 31, 2008 and 2007, respectively. Colin Dyne also holds an interest in William Rast Sourcing. During 2008 and 2007 the Company had sales of \$457,000 and \$172,000 respectively, to William Rast Sourcing. Accounts receivable of \$51,000 and \$42,000 were outstanding from William Rast Sourcing at December 31, 2008 and 2007, respectively.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Due from related parties at December 31, 2008 and 2007 includes \$674,010 and \$625,500, 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 2008 based upon current economic and risk analysis and available information, management established a reserve of \$474,010 for this receivable. During 2007 certain notes payable due to Mr. Dyne were offset against and used to satisfy notes receivable from Mr. Dyne.

Demand notes payable to related parties includes notes and advances to parties related to or affiliated with Mark Dyne, the Chairman of the Board of Directors of the Company and significant stockholder. The balance of Demand notes payable to related parties at December 31, 2008 and 2007 was \$85,000 and \$85,000, respectively. See Note 6 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, 2008 and 2007, sales to this entity were \$70,500 and \$88,500,

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respectively. At December 31, 2008 and 2007, accounts receivable included \$35,000 and \$29,000, respectively, due from this entity. On October 25, 2007, Mr. Burstein resigned as a director of the Company. During the fourth quarter of 2007 the Company terminated the consulting agreement of Mr. Burstein. 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 contract and recorded an accrual of \$263,000 at December 31, 2007 to reflect the liability for consulting costs that would continue to be incurred until November 30, 2008. Consulting fees of \$258,000 and \$291,000 were paid for services provided under this contract for the years ended December 31, 2008 and 2007.

Consulting fees paid to Diversified Investments, a company owned by Mark Dyne, amounted to \$150,000 for each of the years ended December 31, 2008, 2007 and 2006. This consulting arrangement terminates on March 31, 2010. Consulting fees of \$250,000 and \$304,000 were paid for services provided by Colin Dyne, for the years ended December 31, 2008 and 2007, respectively. Mr. Dyne's consulting agreement ended November 30, 2008.

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TALON INTERNATIONAL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 18--QUARTERLY RESULTS (UNAUDITED)

Quarterly results for the years ended December 31, 2008 and 2007 are reflected below:

| | 1ST | 2ND | 3RD | 4TH |
|---------------------------------|----------------|---------------|----------------|----------------|
| ----- | | | | |
| 2008 | | | | |
| ---- | | | | |
| Revenue | \$ 9,985,489 | \$ 17,020,629 | \$ 12,772,021 | \$ 8,392,841 |
| Gross profit | \$ 2,757,965 | \$ 4,900,904 | \$ 3,219,352 | \$ 1,738,902 |
| Operating income (loss) | \$ (1,310,234) | \$ 1,050,875 | \$ (1,716,289) | \$ (3,986,235) |
| Net Income (loss) | \$ (1,838,744) | \$ 598,157 | \$ (2,440,155) | \$ (4,678,044) |
| Basic income (loss) per share . | \$ (0.09) | \$ 0.03 | \$ (0.12) | \$ (0.23) |
| Diluted income (loss) per share | \$ (0.09) | \$ 0.03 | \$ (0.12) | \$ (0.23) |
| ----- | | | | |
| 2007 | | | | |
| ---- | | | | |
| Revenue | \$ 9,090,117 | \$ 13,566,981 | \$ 9,013,135 | \$ 8,859,322 |
| Gross profit | \$ 2,703,615 | \$ 4,017,731 | \$ 2,526,476 | \$ 2,858,913 |
| Operating income (loss) | \$ (613,662) | \$ 878,009 | \$ (3,055,289) | \$ (379,737) |
| Net Income (loss) | \$ (795,344) | \$ 490,493 | \$ (3,681,831) | \$ (935,025) |
| Basic income (loss) per share . | \$ (0.04) | \$ 0.03 | \$ (0.18) | \$ (0.05) |
| Diluted income (loss) per share | \$ (0.04) | \$ 0.02 | \$ (0.18) | \$ (0.05) |
| ----- | | | | |

During 2008, the Company had material charges of \$5.4 million for

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impairments of fixed assets, marketable securities, inventory, severance and related party notes receivable. During 2007, the Company had charges of \$1.1 million for impairment of notes receivable from a former customer and fixed assets.

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 19 - SUBSEQUENT EVENT

On March 31, 2009 we completed an amendment to our existing revolving credit and term loan agreement with CVC California, LLC. The amendment provided for the following: issuance of an additional term note to CVC in the principal amount of \$225,210 in lieu of paying a cash waiver fee in connection with our failure to satisfy the EBITDA requirements for the quarter ended December 31, 2008 and March 31, 2009; deferral of the term note quarterly interest payment of \$215,000 due April 1, 2009; a temporary increase to the borrowing base formulas and calculations under the revolving credit facility; the re-lending by CVC of \$125,000 under the term loan portion of credit facility; a consent to allow us to sell equipment that has been designated as held for sale more fully described in Note 5 to the consolidated financial statements; and the granting to CVC of the right to designate a non-voting observer to attend all meetings of our Board of Directors.

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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 Lonnie D. Schnell, our principal executive and principal financial officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, Mr. Schnell concluded that these disclosure controls and procedures were effective as of the end of the period covered 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

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internal control over financial reporting for the Company. In order to evaluate the effectiveness of internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act, the Company's management has conducted an assessment, including testing, using the criteria in INTERNAL CONTROL - INTEGRATED FRAMEWORK, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Our system of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Based on its assessment, our management has concluded that control over financial reporting was effective as of December 31, 2008.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our independent 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, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following table sets forth the name, age and position of each of our executive officers and directors as of March 31, 2009.

| NAME | AGE | POSITION |
|------------------------|-----|---|
| Mark Dyne (1)..... | 48 | Chairman of the Board of Directors |
| Colin Dyne (1)..... | 46 | Vice Chairman of the Board of Directors |
| Brent Cohen..... | 50 | Director |
| Joseph Miller..... | 45 | Director |
| Raymond Musci | 48 | Director |
| William Sweedler..... | 42 | Director |
| Lonnie D. Schnell..... | 60 | Chief Executive Officer & Chief Financial Officer |
| Larry Dyne (1)..... | 37 | Executive Vice President, Sales |

(1) Mark Dyne, Colin Dyne and Larry Dyne are brothers.

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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

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. Since May 2007, Colin Dyne has served as Chief Executive Officer and a director of People's Liberation, Inc. (OTCBB: PPLB), which designs, markets and sells high-end casual apparel under the brand names "People's Liberation" and "William Rast." 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.

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CLASS I DIRECTORS: TERMS EXPIRING IN 2010

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

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BRENT COHEN

Mr. Cohen has served on the Board of Directors since 1998. Mr. Cohen served as Chief Executive Officer and a director of Dovebid Inc. from August 2005 to February 2008. 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 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

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CLASS II DIRECTORS: TERMS EXPIRING IN 2011

LONNIE D. SCHNELL

Mr. Schnell joined the Company in January 2006 as our Chief Financial Officer, was appointed as Chief Executive Officer in February 2008 and has served on

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

RAYMOND MUSCI

Ray Musci has served as a Director of the Company since June 2005. Mr. Musci serves as a Director and Chief Operating Officer of New Motion, Inc. (NasdaqGM: NWMO), 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. 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

OTHER EXECUTIVE OFFICER

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.

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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, 2008, all of our executive officers, directors and greater-than-ten percent shareholders complied with all Section 16(a) filing requirements, except that one Form 4, reporting five transactions, was filed late by Bluefin Capital LLC, ComVest Capital LLC, ComVest Capital Management LLC, ComVest Group Holdings LLC and Michael Falk.

CODE OF ETHICS

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

ITEM 11. EXECUTIVE COMPENSATION

COMPENSATION DISCUSSION AND ANALYSIS

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 2008 were as follows:

- o Lonnie D. Schnell, Chief Executive Officer & Chief Financial Officer (named Chief Executive Officer as of February 4, 2008); and

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- o Larry Dyne, Executive Vice President of Sales (appointed in February 2008)
- 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)

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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;
- 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

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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.

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MANAGEMENT INCENTIVE BONUSES

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

EQUITY INCENTIVES

Equity incentives are intended to align senior executive and 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.

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

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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.

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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.

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

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is equity-based. In 2008, the long-term incentive program for the named executive officers consisted entirely of stock 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 2008 was \$275,000 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.

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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 6, 2008

EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE

The following table sets forth, as to each person serving as Chief Executive Officer and Chief Financial Officer during 2008, and the one highly compensated executive officer other than the Chief Executive Officer and Chief

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Financial Officer at the end of the 2008 whose compensation exceeded \$100,000 (referred to as "named executive officers"), information concerning all compensation earned for services to us in all capacities for 2008.

| NAME AND PRINCIPAL POSITION | YEAR | SALARY | STOCK AWARDS (4) | OPTION AWARDS (4) | NON-EQUITY INCENTIVE PLAN COMPENSATION |
|---|----------------------|----------------------------------|------------------------|------------------------------|---|
| Lonnie D. Schnell (1) Chief Executive Officer and Chief Financial Officer | 2008 2007 2006 | \$ 275,000 225,000 171,346 | \$ -- -- -- | \$ 63,462 1,917 31,998 | \$ 53,230 45,000 45,025 |
| Larry Dyne Executive Vice President, Sales | 2008 | 250,000 | -- | 53,818 | 40,000 |
| Stephen P. Forte (2) Former Chief Executive Officer | 2008 2007 2006 | 31,250 325,000 275,000 | -- -- 77,468 | 83,469 7,851 73,995 | -- -- 90,050 |
| Wouter van Biene (3) Former Chief Operating Officer | 2008 2007 2006 | 9,519 225,000 180,000 | -- -- -- | 23,366 1,986 27,526 | -- -- 45,025 |

- (1) Mr. Schnell was appointed Chief Executive Officer effective February 4, 2008 and previously served as Chief Financial Officer.
- (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 2008, 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 11 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.

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

MR. SCHNELL

MR. FORTE

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| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
|---------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Severance | \$ -- | \$ -- | \$ -- | 287,645 | \$ -- | \$ -- |
| Health & medical insurance (a) | 13,793 | 11,019 | 12,673 | 9,374 | 8,202 | 12,916 |
| Life & disability insurance (b) | 323 | 324 | 81 | 54 | 4,282 | 81 |
| Automobile allowances | 11,000 | -- | -- | -- | 18,000 | 22,500 |
| Consulting services (c) | -- | -- | 11,880 | -- | -- | -- |
| Total | \$ 25,116 | \$ 11,343 | \$ 24,634 | \$297,073 | \$ 30,484 | \$ 35,497 |

| | MR. VAN BIENE | | | MR. DYNE |
|---------------------------------|------------------|------------------|-----------------|------------------|
| | 2008 | 2007 | 2006 | 2008 |
| Severance | \$234,952 | \$ -- | \$ -- | \$ -- |
| Health & medical insurance (a) | 12,834 | 11,178 | 6,925 | 9,429 |
| Life & disability insurance (b) | 54 | 324 | 81 | 323 |
| Automobile allowances | -- | -- | -- | 6,175 |
| Consulting services (c) | -- | -- | -- | -- |
| Total | \$247,840 | \$ 11,502 | \$ 7,006 | \$ 15,927 |

- (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 2008 compensation for Lonnie Schnell, our Chief Executive Officer was in accordance with our employment agreement with him. The terms and conditions established in this agreement were the result of our consideration of our current operating performance levels, 2007 and 2006 operating performance, our 2005 Restructuring and Strategic Plan, compensation levels for our previous CEO, comparative industry compensation levels and negotiations with Mr. Schnell. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies, and a long-term equity option of 900,000 shares of common stock, representing approximately 4.4% 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 ("MIP"), was established as provided in Mr. Schnell's employment agreement setting aside 12% of the Company's earnings before interest, taxes, depreciation and amortization ("EBITDA") for annual bonus awards to him and the other senior executives. The MIP fund is shown in the table above as non-equity incentive plan compensation. MIP Funds were not

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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.

The 2008 compensation for Larry Dyne, our Executive Vice President, Sales was in accordance with our employment agreement with him. The terms and conditions established in this agreement were the result of our consideration of our current operating performance levels, 2007 and 2006 operating performance, our 2005 Restructuring and Strategic Plan, compensation levels for our previous CEO, comparative industry compensation levels and negotiations with Mr. Dyne. The base compensation was evaluated in conjunction with the long-term equity awards and annual bonus incentives to establish a compensation arrangement providing a substantial incentive for the achievement of our long-term objectives and for adding shareholder value. Accordingly, the base compensation was established near minimum industry levels for the same role in comparable companies, and a long-term equity option of 700,000 shares of common stock, representing approximately 3.4% 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 the MIP, was established as provided in Mr. Dyne's employment agreement setting aside 12% of EBITDA for annual bonus awards to him and the other senior executives.

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Our employment agreement with Steve Forte, our former Chief Executive Officer, provided that 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.

Our employment letter with Wouter van Biene, our former Chief Operating Officer, provided that 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

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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.

GRANTS OF PLAN-BASED AWARDS IN FISCAL 2008

The following table provides information about equity-awards granted to each named executive officer in 2008 under our 2007 and 2008 Stock Plans.

| NAME | GRANT DATE (1) | APPROVAL DATE (1) | ALL OTHER OPTION AWARDS: NUMBER OF SECURITIES UNDERLYING OPTIONS (#) | EXERCISE OR BASE PRICE OF OPTION AWARDS (\$/SH) (2) | MARKET PRICE ON GRANT DATE (\$/SH) (2) | GRANT VALUE AWARD (3) |
|-------------------|-------------------|----------------------|---|--|---|-----------------------------|
| Lonnie D. Schnell | 6/25/08 | 6/18/08 | 900,000 | \$0.20 | \$0.21 | \$140 |
| Larry Dyne | 6/25/08 | 6/18/08 | 700,000 | \$0.20 | \$0.21 | \$109 |

- (1) The grant date of an option award is the date that the compensation committee fixes as the date the recipient is entitled to receive the award. The approval date is the date that the compensation committee approves the award.
- (2) The exercise price of option awards differs from the market price on the date of grant. The exercise price of options granted in 2008 is equal to the average closing sales prices of our common stock for the five trading days prior to and including the grant date, as reported on the OTCBB, while the market price on the date of grant is the closing price of our common stock on that date.
- (3) The grant date fair value is generally the amount the company would expense in its financial statements over the award's service period, but does not include a reduction for forfeitures.

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Option awards granted to our executive officers are for a 10 year term. Each of the option grants in the table above vest in full on December 31, 2010, subject to partial earlier vesting contingent on achievement of certain Company performance targets for 2008 and 2009. The relevant performance targets were not achieved for 2008, and none of the options were vested as of December 31, 2008. Upon a change of control or involuntary termination without cause, the vesting of all options granted to the named executive officers in 2008 is accelerated to the date of termination, as described below under "Employment Agreements, Termination of Employment and Change of Control Arrangements."

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR 2008

The following table provides information with respect to outstanding stock options held by each of the named executive officers as of December 31, 2008:

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| NAME | GRANT DATE | NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS | | OPTION EXERCISE PRICE (\$) | OPT EXPIRAT |
|-------------------|------------|---|----------------------|----------------------------------|----------------|
| | | (#) EXERCISABLE | (#) UNEXERCISABLE | | |
| Lonnie D. Schnell | 1/26/06 | 291,667 (1) | 108,333 (1) | \$0.59 | 1/ |
| | 6/25/08 | -- | 900,000 (2) | \$0.20 | 06/ |
| Stephen P. Forte | 1/16/06 | 135,135 (3) | -- | \$0.37 | 02/ |
| | 1/16/06 | 900,000 (3) | | \$0.37 | 02/ |
| Wouter van Biene | 3/01/06 | 225,695 (4) | -- | \$0.53 | 01/ |
| Larry Dyne | 12/20/99 | 20,000 | -- | \$4.31 | 12/ |
| | 2/28/00 | 15,000 | -- | \$4.62 | 02/ |
| | 4/10/00 | 15,000 | -- | \$4.25 | 04/ |
| | 12/12/00 | 20,000 | -- | \$3.75 | 12/ |
| | 11/18/01 | 15,000 | -- | \$3.64 | 11/ |
| | 12/31/02 | 25,000 | -- | \$3.63 | 12/ |
| | 4/01/03 | 25,000 | -- | \$3.50 | 03/ |
| | 4/08/03 | 45,500 | -- | \$3.70 | 04/ |
| | 4/18/05 | 50,000 | -- | \$3.14 | 04/ |
| | 1/16/06 | 413,194 | 11,806 (5) | \$0.37 | 01/ |
| 6/25/08 | -- | 700,000 (6) | \$0.20 | 06/ | |

- (1) These options become exercisable with respect to 8,333 shares each month until fully vested.
- (2) These options vest in full on December 31, 2010. The options provide for early vesting with respect to up to 600,000 shares each based on the Company's performance as compared to the Board of Directors approved budget for each of 2008 and 2009. There was no early vesting for 2008 based on upon performance.
- (3) Mr. Forte resigned as of February 4, 2008, and the vesting of his outstanding options was fully accelerated pursuant to his separation agreement. Mr. Forte's stock options have expired unexercised subsequent to December 31, 2008.
- (4) 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. Mr. van Biene's stock options have expired unexercised subsequent to December 31, 2008.
- (5) Vests with respect to the remaining shares on January 16, 2009.
- (6) These options vest in full on December 31, 2010. The options provide for early vesting with respect to up to 466,666 shares each based on the Company's performance as compared to the Board of Directors approved budget for each of 2008 and 2009. There was no early vesting for 2008 based on upon performance.

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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 June 18, 2008, we entered into an Executive Employment Agreement with Lonnie D. Schnell, pursuant to which Mr. Schnell serves as our Chief Executive Officer. This employment agreement has a term continuing through December 31, 2010, which may be extended to December 31, 2011. Pursuant to this agreement, Mr. Schnell will receive an annual base salary of \$275,000 for 2008, \$300,000 for 2009 and \$325,000 for each subsequent year of the term and will be entitled to receive an annual incentive bonus, which for 2008 will be based upon our earnings before interest, taxes, depreciation and amortization. Mr. Schnell is entitled to an auto allowance of \$1,000 per month. In the event that prior to the end of the term, Mr. Schnell's employment is terminated by us "without cause" (as defined in the agreement), by Mr. Schnell for "good reason" (as defined in the agreement) or due to Mr. Schnell's death or disability, then conditional upon his execution of a release of claims, Mr. Schnell or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to Mr. Schnell's base salary for the remaining term of the agreement or, in the case of death or disability, through December 31, 2010, (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. Schnell pursuant to the agreement and all other options held by him and (iv) continued medical coverage for Mr. Schnell and his dependents for the remaining term of the agreement. In connection with the employment agreement, Mr. Schnell was granted an option to purchase 900,000 shares of our common stock, which vests in full on December 31, 2010, subject to earlier vesting if Mr. Schnell meets performance criteria established by the Board for fiscal 2008 and 2009. Mr. Schnell's options will vest in full upon a change of control of our company or upon termination of Mr. Schnell's employment without cause, for good reason or due to his death or disability.

LARRY DYNE, EXECUTIVE VICE PRESIDENT, SALES. On June 18, 2008, we entered into an Executive Employment Agreement with Larry Dyne, pursuant to which Mr. Dyne will serve as our Executive Vice President of Global Sales. This employment agreement has a term continuing through December 31, 2010, which may be extended to December 31, 2011. Pursuant to this agreement, Mr. Dyne will receive an annual base salary of \$250,000 for 2008, \$275,000 for 2009 and \$300,000 for each subsequent year of the term and will be entitled to receive an annual incentive bonus, which for 2008 will be based upon our earnings before interest, taxes, depreciation and amortization. Mr. Dyne is entitled to an auto allowance of \$950 per month. In the event that prior to the end of the term, Mr. Dyne's employment is terminated by us "without cause" (as defined in the agreement), by Mr. Dyne for "good reason" (as defined in the agreement) or due to Mr. Dyne's death or disability, then conditional upon his execution of a release of claims, Mr. Dyne or his estate will be entitled to receive, in addition to all accrued salary, (i) severance payments equal to Mr. Dyne's base salary for the remaining term of the agreement or, in the case of death or disability, through December 31, 2010, (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. Dyne pursuant to the agreement and all other options held by him and (iv) continued medical coverage for Mr. Dyne and his dependents for the remaining term of the agreement. In connection with the employment agreement, Mr. Dyne was granted an option to

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purchase 700,000 shares of our common stock, which vests in full on December 31, 2010, subject to earlier vesting if Mr. Dyne meets performance criteria established by the Board for fiscal 2008 and 2009. Mr. Dyne's options will vest in full upon a change of control of our company or upon termination of Mr. Dyne's employment without cause, for good reason or due to his death or disability.

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POTENTIAL SEVERANCE PAYMENTS

As described above, our employment agreements with Lonnie Schnell and Larry Dyne provided for severance benefits in the event that the executive's employment is terminated due to executive's death or disability, by the Company without "cause" or by the executive for "good reason." The following table sets forth severance payments and benefits that we would have been obligated to pay to Messrs. Schnell and Dyne assuming a triggering event had occurred under each of their respective agreements as of December 31, 2008:

| NAME | CASH SEVERANCE PAYMENT (\$) (1) | BONUS VALUE (\$) | CONTINUATION OF HEALTH BENEFITS (\$) | VALUE OF ACCELERATION OF VESTING OF EQUITY AWARDS (\$) (2) |
|-------------------|------------------------------------|---------------------|--|---|
| Lonnie D. Schnell | 654,509 | -- | 27,586 | -- |
| Larry Dyne | 593,872 | -- | 18,858 | -- |

(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, 2008 of \$0.11, as reported by the OTC Bulletin Board.

POTENTIAL CHANGE IN CONTROL PAYMENTS

As described above, our employment agreements with Lonnie Schnell and Larry Dyne provide for accelerated vesting of all or a portion of the options held by such executives upon a change in control. However, as of December 31, 2008, there were no unvested stock options held by the named executive officers that had an exercise price lower than the closing price of our common stock on December 31, 2008 of \$0.11 per share, as reported by the OTC Bulletin Board. As a result, there would have been no value of the accelerated vesting had a change in control occurred on December 31, 2008. Currently, there are no other benefits payable to our named executive officers upon a 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

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responsibility for reviewing and considering any revisions to director compensation.

The following table details the total compensation earned by the company's non-employee directors in 2008.

| NAME | FEES EARNED OR PAID IN CASH | OPTION AWARDS (8) | ALL OTHER COMPENSATION | TOTAL |
|----------------------------|-----------------------------------|----------------------|---------------------------|------------|
| Mark Dyne (1) | \$ 31,500 | \$ 15,571 | \$ -- | \$ 47,071 |
| Colin Dyne (2) | -- | 15,571 | 250,000 | 265,571 |
| Brent Cohen (3) | 35,500 | 15,571 | -- | 51,071 |
| Joseph Miller (4) | 32,500 | 15,571 | -- | 48,071 |
| Raymond Musci (5) | 40,000 | 15,571 | -- | 55,571 |
| William Sweedler (6) | 39,000 | 15,571 | -- | 54,571 |
| | | | | |
| Total | \$ 178,500 | \$ 93,426 | \$ 250,000 | \$ 521,926 |

(1) As of December 31, 2008, Mr. Mark Dyne held options to purchase a total of 305,000 shares. The other compensation consists of consulting and per diem fees earned for services rendered.

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(2) As of December 31, 2008, Mr. Colin Dyne held options to purchase a total of 625,000 shares. The other compensation consists of consulting fees for services rendered.

(3) As of December 31, 2008, Mr. Cohen held options to purchase a total of 165,000 shares. The other compensation consists of consulting fees for services rendered.

(4) As of December 31, 2008, Mr. Miller held options to purchase a total of 120,000 shares.

(5) As of December 31, 2008, Mr. Musci held options to purchase a total of 120,000 shares.

(6) As of December 31, 2008, Mr. Sweedler held options to purchase a total of 90,000 shares.

(7) The amounts in this column represent the dollar amounts recognized for financial statement purposes in fiscal 2008 with respect to stock options granted in 2008 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 2008, see Note 11 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.

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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.

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.

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.

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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, 2008 regarding equity compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance:

| | NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS | WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS | NUMBER OF S REMAINING FOR FUTURE UNDER E COMPENSATI |
|--|--|--|---|
| | ----- | ----- | ----- |
| Equity compensation plans approved by security holders..... | 5,475,536 | \$ 1.14 | 2,250, |
| Equity compensation plans not approved by security holders..... | 1,943,495 | \$ 0.98 | - |
| | ----- | ----- | ----- |
| Total..... | 7,419,031 | \$ 1.10 | 2,250, |
| | ===== | ===== | ===== |

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Options and warrants issued pursuant to equity compensation plans not approved by security holders are summarized as follows:

- 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 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 6, 2009:

- 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 current 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 6, 2009. 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 6, 2009, 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.

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| NAME OF BENEFICIAL OWNER | NUMBER OF SHARES | PERCENT OF CLASS |
|--|------------------|------------------|
| ----- | | |
| DIRECTORS: | | |
| Mark Dyne (1) | 1,140,667 | 5.5% |
| Colin Dyne (2) | 807,780 | 3.9% |
| Larry Dyne (3) | 785,100 | 3.7% |
| Lonnie D. Schnell (4) | 458,333 | 2.2% |
| William Sweedler (5) | 192,000 | * |
| Brent Cohen (6) | 165,000 | * |
| Raymond Musci (6) | 120,000 | * |
| Joseph M. Miller (6) | 120,000 | * |
| Directors and executive officers as a group (8 persons) (7) | 3,788,880 | 16.7% |
| OTHER 5% HOLDERS: | | |
| Bluefin Capital, LLC | 1,750,000 | 8.6% |
| 105 S. Narcissus Ave., Suite 712 West Palm Beach, FL 33401 | | |

* Less than 1%.

- (1) Includes 305,000 shares of common stock reserved for issuance upon exercise of stock options which are currently exercisable and 176,600 shares held by a limited liability company of which Mr. Dyne is the manager and a member.
- (2) Includes 625,000 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable.
- (3) Includes 655,500 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 333,333 shares of common stock reserved for issuance upon exercise of stock options that are currently exercisable or will become exercisable within 60 days.
- (5) Includes 90,000 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 2,413,833 shares of common stock reserved for issuance upon exercise of stock options which currently are exercisable or will become exercisable within 60 days.

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 of Directors approval of transactions with related persons as defined by SEC regulations, including any sales or purchase transaction, asset exchange transaction, operating agreement,

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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

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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, 2008, 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.

Colin Dyne, Vice Chairman of our Board of Directors and a stockholder, is also an executive officer, director and significant shareholder of People's Liberation, Inc., the parent company of Versatile Entertainment, Inc. During 2008, we had sales of \$88,000 to Versatile Entertainment. At December 31, 2008 accounts receivable of \$18,000 were outstanding from Versatile Entertainment. Colin Dyne also holds an interest in William Rast Sourcing. During 2008 we had sales of \$457,000 to William Rast Sourcing. At December 31, 2008 accounts receivable of \$51,000 were outstanding from William Rast Sourcing.

At December 31, 2008, we had \$674,010 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. A reserve was established against this note in the amount of \$474,010 at December 31, 2008.

We paid consulting fees of \$250,000 to Colin Dyne during year ended December 31, 2008 for consulting services provided. The consulting agreement expired on November 30, 2008. See the "Director Compensation" section in item 11 of this report for a description of this agreement.

At December 31, 2008, we had an aggregate of \$85,176 in notes and advances due to Mark Dyne, the Chairman of our Board of Directors and a significant stockholder, or to parties related to or affiliated with Mark Dyne. The notes are payable on demand and accrue interest at 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, 2008.

DIRECTOR INDEPENDENCE

Because our common stock is quoted on the OTC Bulletin Board, we are

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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, 2008, 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.

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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.

SingerLewak LLP served as our independent registered public accounting firm for each of the fiscal years ended December 31, 2008, 2007 and 2006.

AUDIT FEES - The aggregate fees billed by our independent registered public accounting firm for professional services rendered for the audit of our annual financial statements and review of our financial statements included in our Forms 10-Q or services that are normally provided in connection with statutory and regulatory filings were \$468,000 for fiscal year 2008 and \$350,000 for fiscal year 2007.

AUDIT-RELATED FEES - The aggregate fees billed by our independent registered public accounting firm for professional services rendered for assurance and related services reasonably related to the performance of the audit or review of our financial statements (other than those reported above) were \$44,000 for fiscal year 2008 and \$57,300 for fiscal year 2007.

TAX FEES - The aggregate fees billed by our independent registered public accounting firm for professional services rendered for tax compliance, tax advice and tax planning were \$44,000 for fiscal year 2008 and \$33,400 for fiscal year 2007.

ALL OTHER FEES - The aggregate fees billed by our independent public registered accounting firm for services rendered to us other than the services described above under "Audit Fees," "Audit-Related Fees" and "Tax Fees" were \$24,000 for fiscal year 2007 and \$25,400 for fiscal year 2007 which was primarily related governmental regulations not related to our annual or quarterly financial statements.

The audit committee approved all of the foregoing services provided by SingerLewak LLP.

POLICY REGARDING PRE-APPROVAL OF SERVICES PROVIDED BY THE INDEPENDENT AUDITORS

The audit committee has established a general policy requiring its pre-approval of all audit services and permissible non-audit services provided by the independent auditors, along with the associated fees for those services. For both types of pre-approval, the audit committee considers whether the provision of a non-audit service is consistent with the SEC's rules on auditor

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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.

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.

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

| DESCRIPTION | BALANCE AT BEGINNING OF YEAR | ADDITIONS | DEDUCTIONS | BALANCE END OF |
|--|------------------------------------|-----------|------------|-------------------|
| 2008 | | | | |
| ----- | ----- | ----- | ----- | ----- |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 140,500 | \$ 74,500 | \$ (2,300) | \$ 217 |
| Allowance for doubtful accounts deducted from related party in the balance sheet | -- | 474,000 | -- | 474 |
| Reserve for obsolescence deducted from | | | | |

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| | | | | |
|--|----------------------|---------------------|----------------------|----------------------|
| inventories on the balance sheet | 1,019,000 | 692,000 | 500,000 | 1,211,000 |
| Valuation reserve deducted from deferred tax assets | 20,163,000 | 4,947,000 | 1,094,000 | 24,016,000 |
| | <u>\$ 21,322,500</u> | <u>\$ 6,187,500</u> | <u>\$ 1,591,700</u> | <u>\$ 25,918,000</u> |
| 2007 | | | | |
| ---- | | | | |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 71,500 | \$ 135,000 | \$ 66,000 | \$ 140,000 |
| Allowance for doubtful accounts deducted from notes receivable in the balance sheet | -- | 1,088,000 | 1,088,000 | |
| Reserve for obsolescence deducted from inventories on the balance sheet | 1,242,000 | 148,000 | 371,000 | 1,019,000 |
| Valuation reserve deducted from deferred tax assets | 19,225,000 | 938,000 | -- | 20,163,000 |
| Total | <u>\$ 20,538,500</u> | <u>\$ 2,309,000</u> | <u>\$ 1,525,000</u> | <u>\$ 21,322,500</u> |
| 2006 | | | | |
| ---- | | | | |
| Allowance for doubtful accounts deducted from accounts receivable in the balance sheet | \$ 1,189,000 | \$ 198,000 | \$ 1,315,500 | \$ 712,000 |
| 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 | |
| Total | <u>\$ 29,942,000</u> | <u>\$ 755,000</u> | <u>\$ 10,158,500</u> | <u>\$ 20,538,500</u> |

- (1) Additions to the allowance for doubtful accounts include provisions for uncollectible accounts. Bad debt expense includes (and additions above exclude) net direct write-offs of \$0.0 and \$114,000 for the years ended December 31, 2008 and 2007, respectively, and net recoveries of \$712,000 for the year ended December 31, 2006. Additions to the inventory valuation reserve include current year provisions. Additionally, 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 include amounts applied to write-offs and reversals of prior period provisions. Deductions from the inventory valuation reserve include application of the reserve against obsolete, excess, slow-moving or disposed inventory.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on

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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 ----- Lonnie D. Schnell | Chief Executive Officer and Chief Financial Officer (Principal Executive and Financial Officer) | April 9, 2009 |
| /s/ Mark Dyne ----- Mark Dyne | Chairman of the Board of Directors | April 9, 2009 |
| /s/ Colin Dyne ----- Colin Dyne | Vice Chairman of the Board of Directors | April 9, 2009 |
| ----- Brent Cohen | Director | |
| /s/ Raymond Musci ----- Raymond Musci | Director | April 9, 2009 |
| /s/ Joseph Miller ----- Joseph Miller | Director | April 9, 2009 |

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/s/ William Sweedler Director

William Sweedler

April 9, 2009

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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 4.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto. |
| 4.2 | Rights Agreement, dated as of November 4, 1998, between Registrant and American Stock Transfer and Trust Company as Rights Agent. Incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. |
| 4.3 | Form of Rights Certificate. Incorporated by reference to Exhibit B to the Rights Agreement filed as Exhibit 4.1 to Current Report on Form 8-K filed as of November 4, 1998. |
| 10.1 | Form of Indemnification Agreement. Incorporated by reference to Exhibit 10.1 to Form SB-2 filed on October 21, 1997, and the amendments thereto. |
| 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. |

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- 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.

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| 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 | Form of Common Stock Purchase Warrant, dated as of November 9, 2004. Incorporated by reference to Exhibit 10.3 to Form S-3 filed |

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on December 9, 2004.

- 10.16 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.
- 10.17 (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.
- 10.18 (2) 2007 Stock Plan. Incorporated by reference to Exhibit 10.20 to the Form 10-K filed on April 25, 2008.
- 10.19 Revolving Credit and Term Loan Agreement dated June 27, 2007, by and between Tag-It Pacific, Inc. and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.35 to Form 10-Q filed on August 14, 2007.
- 10.19.1 Amendment No. 1 to Loan Agreement dated July 30, 2007, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.20 to the Form 10-K filed on April 25, 2008.

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| EXHIBIT NUMBER ----- | EXHIBIT DESCRIPTION ----- |
|----------------------------|---|
| 10.19.2 | 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. |
| 10.19.3 | Amendment No. 3 to Loan Agreement dated as of March 31, 2008, by and between the Registrant and Bluefin Capital, LLC. Incorporated by reference to Exhibit 10.21.3 to Form 10-Q filed on May 15, 2008. |
| 10.20 | 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. |
| 10.21 | 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. |
| 10.22 | 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 |

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filed on August 10, 2007.

- 10.23 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.
- 10.24 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.
- 10.25 (2) Separation Agreement, dated as of February 4, 2008, between Stephen Forte and Talon International, Inc. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on February 6, 2008.
- 10.26 (2) Executive Employment Agreement, dated June 18, 2008, between Talon International, Inc. and Lonnie Schnell. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on June 24, 2008.
- 10.27 (2) Executive Employment Agreement, dated June 18, 2008, between Talon International, Inc. and Larry Dyne. Incorporated by reference to Exhibit 10.1 to Form 8-K filed on June 24, 2008.
- 10.28 (2) Talon International, Inc. 2008 Stock Incentive Plan. Incorporated by reference to Exhibit 4.10 to Registration Statement on Form S-8 filed on July 18, 2008.
- 14.1 Code of Ethics. Incorporated by reference to Exhibit 14.1 to Form 10-K filed on March 30, 2004.
- 21.1 Subsidiaries.

| EXHIBIT NUMBER ----- | EXHIBIT DESCRIPTION ----- |
|----------------------------|--|
| 23.1 | Consent of SingerLewak 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. |

