ISLAND PACIFIC INC
Form 10-Q/A
November 16, 2004

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

FORM 10-Q/A
(AMENDMENT NO. 1)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2003
OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ____________ TO ____________

Commission file number 0-23049

ISLAND PACIFIC, INC.
(Formerly, SVI Solutions, Inc.)
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	33-0896617
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

19800 MACARTHUR BOULEVARD, 12TH FLOOR, IRVINE, CALIFORNIA	92612
(Address of principal executive offices)	(Zip Code)

(949) 476-2212
(Registrant's telephone number, including area code)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

Common Stock, $0.0001 Par Value - 47,472,554 shares as of November 10, 2003.

EXPLANATORY NOTE

This quarterly report on Form 10-Q/A is an amendment to the Form 10-Q filed by the Company on November 12, 2003 for the quarter ended September 30, 2003.

This quarterly report on Form 10-Q/A is being filed to reflect the restatement of the Company's Condensed Consolidated Financial Statements (the "Restatement"). The Restatement reflects the following:

1. Reversal of revenue recognized on an one-time sale of software technology rights,

2. Presentation of total revenues and cost of revenues as product and services revenues and corresponding costs of revenues,

3. Reclassification of amortization expense of software products from depreciation and amortization expense to cost of product revenue,

4. Capitalization and amortization of debt discount and beneficial conversion charges as interest expense over the term of the debt, and

5. Re-classification of a convertible note payable from equity to liabilities.

The Company will not file an amended Form 10-K/A for the year ended March 31, 2003 due to the immateriality of adjustments. However, certain disclosures that relate to and appear in Form 10-K/A for the year ended March 31, 2003 have been updated in the restated filings.

THIS REPORT DOES NOT OTHERWISE ATTEMPT TO UPDATE THE INFORMATION PROVIDED HEREIN BEYOND THE ORIGINAL FILING DATE.

TABLE OF CONTENTS

2

PART I. - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

ISLAND PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	SEPTEMBER 30, 2003 (As restated - See Note 14)
ASSETS	
Current assets:	
Cash and cash equivalents	$ 1,052
Accounts receivable, net of allowance for doubtful accounts of $203 and $372, respectively	4,614
Income tax refund receivable	846
Other receivables, including $0 and $3 from related parties, respectively	87
Inventories	84
Current portion of non-compete agreements	917
Net assets from discontinued operations	--
Prepaid expenses and other current assets	618
Total current assets	8,218
Note receivable	171
Property and equipment, net	370
Purchased and capitalized software, net	15,846
Goodwill, net	14,795
Non-compete agreements, net	209
Other assets	29
Total assets	$ 39,638
LIABILITIES AND STOCKHOLDERS' EQUITY	

Current Liabilities:	
Debt due to stockholders	$ --
Convertible note	500
Current portion of long-term debts	--
Accounts payable	483
Accrued expenses	2,896
Deferred revenue	1,686
Income tax payable	398
Total current liabilities	5,963
Convertible debentures, net of debt discount of $0 and $625, respectively	--
Convertible note	1,383
Other long-term liabilities	68
Total liabilities	7,414
Commitments and contingencies	
Stockholders' equity:	
Preferred Stock, $.0001 par value; 5,000,000 shares authorized; Series A Convertible Preferred, 7.2% cumulative 141,100 shares authorized and outstanding with a stated value of $100 per share, dividends in arrears of $1,439 and $1,269, respectively	14,100
Committed common stock - 2,500,000 shares	--
Common stock, $.0001 par value; 100,000,000 shares authorized; 43,987,176 and 42,199,632 shares issued; and 43,987,176 and 31,499,632 shares outstanding	4
Additional paid in capital	62,801
Accumulated deficit	(44,681)
Treasury stock, at cost; shares - 10,700,000	--
Total stockholders' equity	32,224
Total liabilities and stockholders' equity	$ 39,638

The accompanying notes are an integral part of these condensed consolidated financial state

ISLAND PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended September 30, 2003	2002	
	(As restated - See Note 14)		(As
Revenues:			
Product	$ 1,825	$ 1,975	$
Services	954	1,822	

Total revenues	2,779	3,797
Cost of revenues:		
Product	1,177	1,185
Services	476	1,157
Total cost of revenues	1,653	2,342
Gross profit	1,126	1,455
Expenses:		
Application development	585	1,343
Depreciation and amortization	280	315
Selling, general and administrative	3,001	1,890
Total expenses	3,866	3,548
Loss from operations	(2,740)	(2,093)
Other income (expense):		
Interest income	(17)	--
Other income (expense)	(167)	3
Interest expense	(1,504)	(985)
Total other expenses	(1,688)	(982)
Loss before provision for income taxes	(4,428)	(3,075)
Provision for income taxes (benefits)	67	1
Loss before cumulative effect of a change in accounting principle	(4,495)	(3,076)
Cumulative effect of changing accounting principle - goodwill valuation under SFAS 142	--	--
Loss from continuing operations	(4,495)	(3,076)
Income from discontinued operations of the SVI Training Products Inc, subsidiary, net of applicable income taxes	--	109
Net loss	(4,495)	(2,967)
Cumulative preferred dividends	(282)	(254)
Net loss available to common stockholders	$ (4,777)	$ (3,221)
Basic and diluted earnings (loss) per share:		
Loss before cumulative effect of a change in accounting principle	$ (0.13)	$ (0.10)
Cumulative effect of a change in accounting principle - goodwill valuation under SFAS 142	--	--
Loss from continuing operations	(0.13)	(0.10)
Income from discontinued operations	--	--
Cumulative preferred dividends	(0.01)	(0.01)
Net loss available to common stockholders	$ (0.14)	$ (0.11)

Basic and diluted weighted-average common shares outstanding:	34,417	28,855

The accompanying notes are an integral part of these condensed consolidated financial

4

ISLAND PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	SIX MONTHS END 2003 (As restated
Cash flows from operating activities:	
Net loss	$(4,191)
Adjustments to reconcile net loss to net cash used for operating activities:	
Depreciation and amortization	1,766
Cumulative effect of a change in accounting principle - goodwill valuation under SFAS 142	--
Gain on disposal of furniture and equipment	169
Amortization of debt discount and conversion option	1,542
Stock-based compensation	126
Common stock issued for services rendered	25
Changes in assets and liabilities net of effects from acquisitions:	
Accounts receivable and other receivables	(630)
Income tax refund receivable	(846)
Inventories	7
Prepaid expenses and other assets	(363)
Accounts payable and accrued expenses	(3,880)
Income tax payable	398
Accrued interest on stockholders' loans, convertible notes and term loan	187
Deferred revenue	125
Net cash used for operating activities	(5,565)
Cash flows from investing activities:	
Payment received from note receivable	9
Purchases of furniture and equipment	(264)
Capitalized software development costs	(2,243)
Net cash used for investing activities	(2,498)
Cash flows from financing activities:	
Sale of common stock, net of offering costs	7,232
Decrease in amount due to stockholders, net	--
Proceeds from committed stock	700
Payments on term loan and debentures	(135)
Proceeds from short-term loan from related party	--
Payments on short-term loan from related party	--
Net cash provided by financing activities	7,797
Effect of exchange rate changes on cash	(1)

Net decrease in cash and cash equivalents	(267)
Cash and cash equivalents, beginning of period	1,319
Cash and cash equivalents, end of period	$ 1,052
Supplemental disclosure of cash flow information:	
Interest paid	$ 134
Supplemental schedule of non-cash investing and financing activities:	
Issued 4,103,161 shares of common stock upon conversion of the 9% debentures	$ 4,200
Issued 2,287,653 shares of common stock upon conversion of the note due to stockholders	$ 1,374
Issued 500,000 shares of common stock as payment for dividend on preferred stock	$ 421
Retired 10,700,000 shares of treasury stock	$(8,906)
Issued 100,000 shares of common stock for services in connection with an equity financing in December 2000	--
Issued 140,000 shares of common stock to pay for penalty for late effectiveness of the registration statement	--
Received 262,500 shares of common stock related to early termination of a service contract	--
Issued 84,849 and 568,380 shares of common stock as payments for bonuses and services rendered in prior periods	$ 83

The accompanying notes are an integral part of these condensed consolidated financial state

ISLAND PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - ORGANIZATION AND BASIS OF PREPARATION

The accompanying unaudited condensed consolidated financial statements (as restated) have been prepared in accordance with generally accepted accounting principles applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments necessary to present fairly the financial position, results of operations and cash flows at September 30, 2003 and for all the periods presented have been made.

Certain amounts in the prior periods have been reclassified to conform to the presentation for the three and six months ended September 30, 2003. The financial information included in this quarterly report should be read in conjunction with the consolidated financial statements and related notes thereto in our Form 10-K/A for the year ended March 31, 2003.

The results of operations for the three and six months ended September 30, 2003 and 2002 are not necessarily indicative of the results to be expected for the full year.

NOTE 2 - DISCONTINUED OPERATIONS

Effective April 1, 2003, we sold our wholly-owned subsidiary, SVI Training Products, Inc. ("Training Products"), to its former president, for the sale price of $180,000 plus earn-out payments equal to 20% of the total gross revenues of Training Products in each of its next two fiscal years, to the extent the revenues in each of those years exceed certain target. We received a promissory note for the amount of $180,000 and the earn-out payments, if any, will be made in quarterly installments following each fiscal year, bearing an annual interest rate of 5%. The note has a balance of $171,000 at September 30, 2003.

The sale of the Training Products subsidiary resulted in a loss of $129,000, net of estimated income taxes, which was accrued for at March 31, 2003. Accordingly, the operating results of the Training Products subsidiary for the three and six months ended September 30, 2002 were restated as discontinued operations.

NOTE 3 - INVENTORIES

Inventories consist of finished goods and are stated at the lower of cost or market, on a first-in, first-out basis.

NOTE 4 - CONVERTIBLE DEBTS

CONVERTIBLE NOTES DUE TO STOCKHOLDERS

During the quarter ended June 30, 2001, we entered into subscription agreements with a limited number of accredited investors related to existing stockholders for gross proceeds of $1.3 million. Each unit consisted of a convertible promissory note to purchase 250 shares of our common stock for each $1,000 borrowed by us. The holders of the notes had the option to convert the unpaid principal and interest to common stock at any time at a conversion price of $0.60 per share. The notes matured on September 30, 2003 and earned interest at 8% per annum, increasing to 13% in the event of a default in payment of principal or interest, to be paid at maturity. We did not have a right to prepay the notes. In September 2003, these investors converted all outstanding balances of principal and accrued interest totaling $1.4 million into 2,287,653 shares of our common stock.

We also issued to these investors warrants to purchase an aggregate of 1,600,000 shares at $0.60 per share, expiring July 19, 2007. The warrants are not callable by us. No warrants have currently been exercised.

We filed a registration statement for the resale of all shares held by or obtainable by these and other investors. The registration statement was declared effective on July 18, 2003.

CONVERTIBLE NOTE DUE TO UNION BANK OF CALIFORNIA

Pursuant to the Discounted Loan Payoff Agreement dated March 31, 2003, we issued to Union Bank of California a $500,000 unsecured, non-interest bearing convertible note payable in either cash or shares of common stock, at our option. If we elect to pay the principal amount or any portion thereof in shares of common stock, the shares will be computed on a price per share of 80% of the average share closing price of our common stock for the ten trading day period immediately preceding the payoff date. The maturity date is March 31, 2004. As of September 30, 2003, the bank had assigned the note to an unrelated party.

CONVERTIBLE NOTE DUE TO TOYS "R" US, INC. (RESTATED)

In May 2002, Toys "R" Us, Inc. ("Toys"), our major customer, agreed to invest $1.3 million for the purchase of a non-recourse convertible note and a warrant to purchase 2,500,000 shares of common stock. In connection with this transaction, Toys signed a two-year software development and services agreement (the "Development Agreement") that expires in February 2004. The note is non-interest bearing, and the face amount is either convertible into shares of our common stock valued at $0.553 per share or payable in cash at our option, at the end of the term. The note is due May 29, 2009, or if earlier than that date, three years after the completion of the development project contemplated in the Development Agreement. We do not have the right to prepay the convertible note before the due date. The face amount of the note is 16% of the $1.3 million purchase price as of May 29, 2002, and increases by 4% of the $1.3 million purchase price on the last day of each succeeding month, until February 28, 2004, when the face amount is the full $1.3 million purchase price. The face amount will cease to increase if Toys terminates the Development Agreement for a reason other than the Company's breach. The face amount will be zero if we terminate the Development Agreement due to an uncured breach by Toys of the Development Agreement.

The warrant entitles Toys to purchase up to 2,500,000 of the shares of our common stock at $0.553 per share. The warrant is initially vested as to 400,000 shares as of May 29, 2002, and vests at the rate of 100,000 shares per month until February 28, 2004. The warrant will cease to vest if Toys terminates the Development Agreement for a reason other than the Company's breach. The warrant will become entirely non-exercisable if the Company terminates the Development Agreement due to an uncured breach by Toys of the Development Agreement. Toys may elect a "cashless exercise" where a portion of the warrant is surrendered to pay the exercise price.

The note conversion price and the warrant exercise price are each subject to a 10% reduction in the event of an uncured breach by us of certain covenants to Toys. These covenants do not include financial covenants. Conversion of the note and exercise of the warrant each require 75 days advance notice. We also granted Toys certain registration rights for the shares of our common stock into which the note is convertible and the warrant is exercisable.

In November 2002, the Board decided that this note will be converted solely for equity and will not be repaid in cash. The note had therefore been classified as equity at March 31, 2003. However, in order to comply with SFAS 150, "Accounting for Certain Financial Instruments Uncertainties of Both Liabilities and Equity", we have re-classified this note from equity to liabilities at September 30, 2003. Subsequent to September 30, 2003, the note was repaid by offsetting against outstanding receivables from Toys as opposed to the issuance of common stock.

In accordance with generally accepted accounting principles, the difference between the conversion price of the note of $0.553 and our stock price on the date of issuance of the notes amounted to $473,000 and being amortized over the term of the note. A total of 151,000 had been amortized during the period of the date of issuance to the date the note was classified as equity. At September 30, 2002 when the note was classified as equity, the remaining balance of $322,000 was expensed.

We have also allocated the proceeds received from debt or convertible debt with detachable warrants using the relative fair value of the individual elements at the time of issuance. The amount allocated to the warrants was $406,000 and being amortized over the term of the note. A total of $19,000 had been amortized during the period from the date of issuance to the date the note was classified as equity. At September 30, 2002 when the note was classified as equity, the remaining balance of $387,000 was expensed.

CONVERTIBLE DEBENTURES (RESTATED)

In March 2003, we entered into a Securities Purchase Agreement for the sale of convertible debentures to a group of investors (the "March '03 Debenture Investors"). The debentures were convertible into shares of our common stock at a conversion price of $1.02 per share, for the total proceeds of $3.5 million. The debentures would have matured in May 2005 and bore an interest rate of 9% per annum. Interest was payable on a quarterly basis commencing on June 1, 2003, in cash or shares of common stock, at our option. If certain conditions were met, we had the right, but not the obligation, to redeem the debentures at 110% of their face value, plus accrued interest. Commencing in February 2004, we would have been obligated to redeem $219,000 per month of the debentures. In August 2003, the daily volume weighted average price of our common stock on the American Stock Exchange exceeded $1.02 by more than 200% for 15 consecutive trading days; therefore, we exercised our option to cause the investors to convert their debentures into common stock. As a result, the investors converted all of their debentures into an aggregate of 3,419,304 shares of our common stock in the quarter ended September 30, 2003.

We filed a registration statement covering 130% of the common stock issuable upon the conversion of the debentures and warrants. The registration statement was declared effective on July 18, 2003.

Additional debentures, aggregating up to $2 million, will be sold to these investors in a second closing, if within one year after the date of first sale of debentures there occurs a period of 15 consecutive trading days during which the daily volume weighted average closing price of our common stock is maintained at a price at or above $1.75 per share, subject to certain conditions. The shares of common stock underlying these debentures and warrants were not included in the registration statement declared effective in July 2003. Neither the investors nor we have executed the second closing as of September 30, 2003.

In accordance with generally accepted accounting principles, the difference between the conversion price of $1.02 and our stock price on the date of issuance of the debentures amounted to $715,000 and was being amortized over the term of the debentures. A total of $165,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debentures into common stock, the remaining balance of $550,000 was expensed.

The March '03 Debenture Investors also received warrants to purchase up to, in the aggregate, 1,572,858 shares of common stock with an exercise price equal to $1.02 per share. The warrants expire five years from the date of issuance. We allocated the proceeds received from debt or convertible debt with detachable warrants using the relative fair value of the individual elements at the time of issuance. The amount allocated to the warrants was $625,000 and was being amortized over the term of the convertible debentures. A total of $144,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debentures into common stock, the remaining balance of $481,000 was expensed.

In April 2003, we entered into a Securities Purchase Agreement with an investor (the "April '03 Debenture Investor") for the sale of a 9% debenture, convertible to shares of our common stock at a conversion price of $1.02, for the gross proceeds of $400,000. Interest was due on a quarterly basis commencing on June

1, 2003, payable in cash or shares of common stock at our option. Commencing on February 1, 2004, we would have been obligated to redeem $20,000 per month of the debenture. The debenture would have matured in October 2005. In August 2003, the daily volume weighted average price of our common stock on the American Stock Exchange exceeded $1.02 by more than 200% for 15 consecutive trading days; therefore, we exercised the option to cause this investor to convert its debenture into common stock. As a result, the April '03 Debenture Investor converted its debenture into 390,777 shares of our common stock in the quarter ended September 30, 2003.

The April '03 Debenture Investor was also granted registration rights under a registration rights agreement, and certain other rights similar to those granted to the March '03 Debenture Investors.

In accordance with generally accepted accounting principles, the difference between the conversion price of $1.02 and our stock price on the date of issuance of the debentures amounted to $69,000 and was being amortized over the term of the debenture. A total of $16,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debenture into common stock, the remaining balance of $53,000 was expensed.

The debenture issued to the April '03 Debenture investor was accompanied by a five-year warrant to purchase 156,311 shares of our common stock with an exercise price of $1.02 per share. We allocated the proceeds received from debt or convertible debt with detachable warrants using the relative fair value of the individual elements at the time of issuance. The amount allocated to the warrants was determined to be $63,000 and was being amortized as interest expense over the term of the convertible debenture. A total of $15,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debentures into common stock, the remaining balance of $48,000 was expensed.

In May 2003, we entered into an agreement with a group of investors (the "May '03 Debenture Investors") for the sale of 9% debentures, convertible into shares of our common stock at a conversion price of $1.02 for the gross proceeds of $300,000. Interest was due on a quarterly basis commencing on June 1, 2003, payable in cash or shares of common stock at our option. Commencing on February 1, 2004, we would have been obligated to redeem $19,000 per month of the debentures. In August 2003, the daily volume weighted average price of our common stock on the American Stock Exchange exceeded $1.02 by more than 200% for 15 consecutive trading days; therefore, we exercised the option to cause the investors to convert their debentures into common stock. As a result, the May '03 Debenture Investors converted their debentures into an aggregate of 293,083 shares of our common stock in the quarter ended September 30, 2003.

The debentures would have been matured in May 2005. The May '03 Debenture Investors were also granted registration rights under a registration rights agreement, and certain other rights similar to those granted to the March '03 Debenture Investors.

Additional debentures aggregating up to $300,000 will be sold to the May '03 Debenture Investors in a second closing, if within one year after the date of first sale of debentures there occurs a period of 15 consecutive trading days during which the daily volume weighted average closing price of our common stock is maintained at a price at or above $1.75 per share, subject to certain conditions. The shares of common stock underlying these debentures and warrants were not included in the registration statement declared effective in July 2003. Neither the investors nor we have executed the second closing as of the date of this report.

In accordance with generally accepted accounting principles, the difference between the conversion price of $1.02 and our stock price on the date of issuance of the debentures amounted to $38,000 and was being amortized over the term of the debentures. A total of $7,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debentures into common stock, the remaining balance of $31,000 was expensed.

These debentures were accompanied by five-year warrants to purchase an aggregate of 101,112 shares of common stock with an exercise price of $1.02 per share. We allocated the proceeds received from debt or convertible debt with detachable warrants using the relative fair value of the individual elements at the time of issuance. The amount allocated to the warrants is $39,000 and was being amortized as interest expense over the life of the convertible debentures. A total of $7,000 had been amortized during the period from the date of issuance to the date of conversion into common stock. Upon conversion of the debentures into common stock, the remaining balance of $32,000 was expensed.

In June 2003, we entered into an agreement with various institutional investors ("Common Stock Institutional Investors") for the sale of 5,275,000 shares of common stock at a per share price of $1.50 for an aggregate purchase price of $7.9 million. In connection with this financing, we paid Roth Capital Partners, LLC, as placement agent, cash compensation of 8% of the proceeds and issued a five-year warrant to purchase 527,500 shares of common stock at an exercise price of $1.65 per share. We also issued five-year warrants to purchase 375,000 shares of common stock at an exercise price of $1.65 to the March '04 Debenture Investors and May '04 Debenture Investors in order to obtain their requisite consents and waivers of rights they possessed to participate in the financing. We filed a registration statement covering the shares sold and warrants issued in connection with this transaction. The registration statement was declared effective September 26, 2003.

NOTE 5 - INCOME TAX BENEFITS

Income tax benefits for the six months ended September 30, 2003 include $846,000 income tax refund receivable; offset in part by income tax payable relating to prior periods of $271,000. The net amount of $570,000 has been recorded as income under provision for income taxes in the consolidated statement of operations in the six months ended September 30, 2003. The income tax refund resulted from carrying back net operating losses in the last three years to prior periods.

NOTE 6 - CHANGE IN ACCOUNTING PRINCIPLE

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives but requires that these assets be reviewed for impairment at least annually or on an interim basis if an event occurs or circumstances change that could indicate that their value has diminished or been impaired. Other intangible assets will continue to be amortized over their estimated useful lives. In addition, the standard includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the identification of reporting units for purposes of assessing potential future impairments of goodwill.

Effective April 1, 2002, we adopted SFAS 142 and ceased amortization of goodwill recorded in business combinations prior to June 30, 2001. We evaluate the remaining useful lives of these intangibles on an annual basis to determine whether events or circumstances warrant a revision to the remaining period of amortization.

Pursuant to SFAS 142, we completed the transitional analysis of goodwill impairment as of April 1, 2002 and recorded an impairment of $627,000 as a cumulative effect of a change in accounting principle in the quarter ended June 30, 2002.

NOTE 7 - PREFERRED STOCK

The Series A Preferred has a stated value of $100 per share and is redeemed at our option any time prior to the maturity date of December 31, 2006 for 107% of the stated value and accrued and unpaid dividends. The preferred shares are entitled to cumulative dividends of 7.2% per annum, payable semi-annually, and have accumulative dividends of $1.4 million and $10.21 and $777,000 of $5.46 per share, at September 30, 2003 and 2002, respectively. The holders may convert each share of Series A Preferred at any time into the number of shares of our common stock determined by dividing the stated value plus all accrued and unpaid dividends, by a conversion price initially equal to $0.80. The conversion price will increase at an annual rate of 3.5% calculated on a semi-annual basis. The conversion price as of September 30, 2003 is $0.84. The Series A Preferred is entitled upon liquidation to an amount equal to its stated value plus accrued and unpaid dividends in preference to any distributions to common stockholders. The Series A Preferred has no voting rights prior to conversion into common stock, except with respect to proposed impairments of the Series A Preferred rights and preferences, or as provided by law. We have the right of first refusal to purchase all but not less than all of any shares of Series A Preferred or shares of common stock received on conversion which the holder may propose to sell to a third party, upon the same price and terms as the proposed sale to a third party.

NOTE 8 - EARNINGS (LOSS) PER SHARE (RESTATED)

Basic earnings (loss) per common share are calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period. Diluted earnings per common shares ("diluted EPS") reflect the potential dilutive effect, determined by the treasury method, of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Earnings per share for the three and six months ended September 30, 2003 and 2002 is calculated as follows (in thousands):

	Three months ended September 30, 2003	2002	Six months ended 2003
Net loss available to common stockholders	$ (4,777)	$ (3,221)	$ (4,745)
Basic and diluted weighted average shares	34,417	28,855	33,264
Basic and diluted loss per share	$ (0.14)	$ (0.11)	$ (0.14)

The following potential common shares have been excluded from the computation of diluted net loss per share for the three and six months ended September 30, 2002, because the effect would have been anti-dilutive:

	2003	2002
Outstanding options under our stock option plans	4,866,240	5,181,082
Outstanding options granted outside our stock option plans	5,054,312	5,074,312
Warrants issued in conjunction with private placements	6,330,281	4,232,000
Warrants issued for services rendered	748,169	804,002
Convertible notes	223,214	2,083,333
Convertible note due to a major customer	2,500,000	2,500,000
Series A Convertible Preferred Stock	18,444,424	18,576,750
Total	38,116,640	38,451,479

NOTE 9 - BUSINESS SEGMENTS AND GEOGRAPHIC DATA (AS RESTATED)

We are a provider of software solutions and services to the retail industry. We provide high value innovative solutions that help retailers understand, create, manage and fulfill consumer demand. Our solutions and services have been developed specifically to meet the needs of the retail industry. Our solutions help retailers improve the efficiency and effectiveness of their operations and build stronger, longer lasting relationships with their customers. We currently operate in the United States and the United Kingdom. The geographic distribution of our revenues and long-lived assets are as follows (in thousands):

	Three months ended September 30, 2003	2002	Six months ended September 2003	2002
	(As restated)		(As restated)	
Revenues:				
United States	$ 2,288	$ 3,224	$ 7,214	$ 7,652
United Kingdom	491	573	1,031	1,038
Total revenues	$ 2,779	$ 3,797	$ 8,245	$ 8,690

	September 30, 2003	March 31, 2003
	(As restated)	
Identifiable assets from continuing operations:		
United States	$ 39,021	$ 37,146
United Kingdom	617	491
Total identifiable assets	$ 39,638	$ 37,637

For the three months ended September 30, 2003 and 2002, revenues from one major customer represents 7% and 27%, respectively, of total revenues. Revenues from this major customer represents 18% and 35% of total revenues for the six months ended September 30, 2003 and 2002, respectively. The accounts receivable balance from this major customer at September 30, 2003 and 2002 represents 45% and 9% of total accounts receivable.

We organize our business into two segments as follows:

- RETAIL MANAGEMENT SOLUTIONS - offer suite of applications, which builds on our long history in retail software design and development. We provide our customers with an extremely reliable, widely deployed, comprehensive and fully integrated retail management solutions. Retail Management Solutions include merchandise management that optimizes workflow and provides the highest level of data integrity. This module supports all operational areas of the supply chain including planning, open-to-buy purchase order management, forecasting, warehouse and store receiving distribution, transfers, price management, performance analysis and physical inventory. In addition, Retail Management Solutions include a comprehensive set of tools for analysis and planning, replenishment and forecasting, event and promotion management, warehouse, ticketing, financials and sales audit. Through collaborations with strategic partners, Retail Management Solutions offer tools for loss prevention, communication with stores and vendors, integration needs, purchase and allocation decisions, analysis of weather impact, control and management of business processes, consumer research, tracking consumer shopping patterns, forecasting and replenishment, and analyzing store people productivity.

- STORE SOLUTIONS - offer suite of applications builds on our long history of providing multi-platform, client server in-store solutions. We market this set of applications under the name "OnePointe," and "OnePointe International" which is a full business to consumer software infrastructure encompassing a range of integrated store solutions. "OnePointe" is a complete application providing all point-of-sale ("POS") and in-store processor (server) functions for traditional "brick and mortar" retail operations.

A summary of the revenues and operating income (loss) attributable to each of these business units and identifiable assets is as follows (in thousands):

	Three months ended September 30, 2003	Three months ended September 30, 2002	Six Se 2003
	(As restated)		(A
Revenues:			
Retail Management Solutions	$ 2,406	$ 3,528	$ 7,47
Store Solutions	373	269	77
	$ 2,779	$ 3,797	$ 8,24
Operating income (loss):			
Retail Management Solutions	$ (1,345)	$ (1,040)	$ (37
Store Solutions	(415)	(416)	(63
Other (see below)	(980)	(637)	(1,71
Total operating income (loss)	$ (2,740)	$ (2,093)	$ (2,72
Depreciation:			
Retail Management Solutions	$ 35	$ 50	$ 6
Store Solutions	7	13	1
Other (see below)	8	23	2
Total depreciation	$ 50	$ 86	$ 10
Other operating loss:			
Depreciation	$ (8)	$ (23)	$ (25
Administrative costs and other non-allocated expenses	(972)	(614)	(1,690
Total other operating loss	$ (980)	$ (637)	$(1,715

	September 30, 2003	March 31, 2003
	(As restated)	
Identifiable assets:		
Retail Management Solutions	$ 33,328	$ 31,953
Store Solutions	4,410	4,404
Total	$ 37,738	$ 36,357
Goodwill, net of amortization:		
Retail Management	$ 13,903	$ 13,903
Store Solutions	892	892
Total	$ 14,795	$ 14,795

Operating income (loss) in Retail Management Solutions and Store Solutions includes direct expenses for software licenses, maintenance services, programming and consulting services, sales and marketing expenses, product development expenses, and direct general and administrative expenses. The "Other" caption includes non-allocated costs and other expenses that are not directly identified with a particular business unit and which management does not consider in evaluating the operating income of the business unit.

NOTE 10 - RECENT ACCOUNTING PRONOUNCEMENTS (AS RESTATED)

In April 2003, the FASB issued Statement of Financial Accounting Standards No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 further clarifies accounting for derivative instruments. We believe the adoption of this statement will have no material impact on our consolidated financial statements.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity," ("SFAS 150"). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Upon adoption of SFAS 150, the convertible note due to Toys was re-classified from equity to liabilities (see Note 4 under "Convertible Note Due to Toys "R" Us, Inc.").

NOTE 11 - COMMITMENTS AND CONTINGENCIES

In June 2003, we entered into a development and marketing license agreement with a software and services company affiliated with one of our officers. Under this agreement, we obtain an exclusive right to sell and distribute this company's software. In return, we committed to fund $1.2 million toward development of this product. We also agreed to pay a royalty of 30% of the software license revenues up until we have recuperated all the development funding, at which point the royalty will increase to 50% thereafter. As of September 30, 2003, we've funded $275,000 toward development.

In September 2003, we entered into an agreement in principle to acquire Page Digital, Inc. for $7 million. This purchase has not yet been finalized as of the date of this report.

In April of 2002, our former CEO, Thomas Dorosewicz, filed a demand with the California Labor Commissioner for $256,250 in severance benefits allegedly due under a disputed employment agreement, plus attorney's fees and costs. Mr. Dorosewicz's demand was later increased to $283,894. On June 18, 2002, we filed an action against Mr. Dorosewicz, Michelle Dorosewicz and an entity affiliated with him in San Diego Superior Court, Case No. GIC790833, alleging fraud and other causes of action relating to transactions Mr. Dorosewicz caused us to enter into with his affiliates and related parties without proper board approval. On July 31, 2002, Mr. Dorosewicz filed cross-complaints in that action alleging breach of statutory duty, breach of contract, fraud and other causes of action related to his employment with us and other transactions he entered into with us. This dispute was heard before an arbitrator during the week ended

October 3, 2003, and a decision from the arbitrator should be forthcoming.

We decided in the third quarter of fiscal 2002 to sell certain assets of our Australian subsidiary to the former management of such subsidiary, and then cease Australian operations. Such sale was, however, subject to the approval of National Australia Bank, the subsidiary's secured lender. The bank did not approve the sale and the subsidiary ceased operations in February 2002. The bank caused a receiver to be appointed in February 2002 to sell substantially all of the assets of the Australian subsidiary and pursue collections on any outstanding receivables. The receiver proceeded to sell substantially all of the assets for $300,000 in May 2002 to an entity affiliated with former management, and is actively pursuing the collection of receivables. If the sale proceeds plus collections on receivables are insufficient to discharge the indebtedness to National Australia Bank, we may be called upon to pay the deficiency under our guarantee to the bank. We have reserved $187,000 as our potential exposure. The receiver has also claimed that we are obligated to it for inter-company balances of $636,000, but we do not believe any amounts are owed to the receiver, who has not as of the date of this report acknowledged the monthly corporate overhead recovery fees and other amounts charged by us to the Australian subsidiary offsetting the amount claimed to be due.

On May 15, 2002, an employee who is currently out on disability/worker's compensation leave, Debora Hintz, filed a claim with the California Labor Commissioner seeking $41,000 in alleged unpaid commissions. In or about December of 2002, Ms. Hintz filed a discrimination claim against us with the Department of Fair Employment and Housing, alleging harassment and sexual orientation discrimination. We have responded appropriately to both the wage claim and the discrimination allegations, which we believe lack merit based on present information.

On August 30, 2002, Cord Camera Centers, Inc., an Ohio corporation ("Cord Camera"), filed a lawsuit against one of our subsidiaries, SVI Retail, Inc. as the successor to Island Pacific Systems Corporation, in the United States District Court for the Southern District of Ohio, Eastern Division, Case No. C2 02 859. The lawsuit claimed damages in excess of $1.5 million, plus punitive damages of $250,000, against SVI Retail for alleged fraud, negligent misrepresentation, breach of express warranties and breach of contract. These claims pertained to the following agreements between Cord Camera and Island Pacific: (i) a License Agreement, dated December 1999, as amended, for the use of certain software products, (ii) a Services Agreement for consulting, training and product support for the software products and (iii) a POS Software Support Agreement for the maintenance and support services for a certain software product. The parties settled this matter in September 2003 and the terms of the settlement are covered by a confidentiality agreement.

In mid-2002, we were the subject of an adverse judgment entered against us in favor of Randall's Family Golf Centers, ("Randall") in the approximate sum of $61,000. The judgment was entered as a default judgment, and is based on allegations that the Company received a preferential transfer of funds within 90 days of the filing by Randall of a chapter 11 case in the United States Bankruptcy Court for the Southern District of New York. We and Randall have agreed to settle this claim for $12,500, subject to the settlement receiving approval by the U.S. Bankruptcy Court.

On November 22, 2002, UDC Homes, Inc and UDC Corporation now known as Shea Homes, Inc. served Sabica Ventures, Inc. ("Sabica") and Island Pacific, an operating division of SVI Solutions, Inc. ("Island Pacific") with a cross-complaint for indemnity on behalf of an entity identified in the summons as Pacific Cabinets. Sabica and Island Pacific filed a notice of motion and motion to quash service of summons on the grounds that neither Sabica nor Island Pacific has ever done business as Pacific Cabinets and has no other known relation to the construction project that is the subject of the cross-complaint and underlying complaint. A hearing on Sabica's and Island Pacific's motion to quash occurred on May 22, 2003 which was subsequently denied.

Certain of our standard software license agreements contain a limited infringement indemnity clause under which we agree to indemnify and hold harmless our customers and business partners against certain liability and damages arising from claims of various copyright or other intellectual property infringement by our products. These terms constitute a form of guarantee that is subject to the disclosure requirements, but not the initial recognition or measurement provisions of Financial Accounting Standards Board issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of others." We have never lost an infringement claim and our cost to defend such lawsuits have been insignificant. Although it is possible that in the future third parties may claim that our current or potential future software solutions infringe on their intellectual property, we do not currently expect a significant impact on our business, operating results or financial condition.

Except as set forth above, we are not involved in any material legal proceedings, other than ordinary routine litigation proceedings incidental to our business, none of which are expected to have a material adverse effect on our financial position or results of operations. However, litigation is subject to inherent uncertainties, and an adverse result in existing or other matters may arise from time to time which may harm our business.

NOTE 12 - RELATED-PARTY TRANSACTIONS

We retain our former CEO and Chairman of the Board to provide consulting services starting August 2003. For the quarter and six months ended September 30, 2003, the expense for this service was $74,000.

We retained an entity owned by an immediate family member of our CEO and Chairman to provide recruiting services. For the six months ended September 30, 2003, the expense for this service was $108,000.

In June 2003, we entered into a development and marketing license agreement with a software and services company affiliated with one of our officers. Under this agreement, we obtain an exclusive right to sell and distribute this company's software. In return, we committed to fund $1.2 million toward development of this product. We also agreed to pay a royalty of 30% of the software license revenues up until we have recuperated all the development funding, at which point the royalty will increase to 50% thereafter. As of September 30, 2003, we've funded $275,000 toward development.

NOTE 13 - SUBSEQUENT EVENTS

In October 2003, Donald Radcliffe resigned as a member of our Board Directors.

On November 7, 2003, we entered into an agreement with various institutional investors ("November 2003 Institutional Investors") for the sale of 3,180,645 shares of common stock at a price of $1.55 per share for an aggregate purchase price of $4.9 million. We also granted the November 2003 Institutional Investors registration rights under a registration rights agreement in which we agree to file a registration statement with the Securities and Exchange Commission for the resale of all shares sold these investors. If the registration statement is not filed by December 7, 2003, we will be obligated to pay on December 7, 2003, and each monthly anniversary until the registration statement is filed, an amount in cash, as liquidated damages, equal to 2.0% of the purchase price paid by the November 2003 Institutional Investors.

In connection with this financing, we paid Roth Capital Partners, LLC ("Roth Capital"), as placement agent, a compensation of $179,000 in cash and 115,226 shares of our common stock and issued a five-year warrant to purchase 282,065 shares of our common stock at an exercise price of $1.71 per share. Roth Capital was granted the registration rights similar to those granted to the November 2003 Institutional Investors.

NOTE 14 - RESTATEMENTS

Subsequent to the issuance of our condensed consolidated financial statements for the three and six months ended September 30, 2003, our management determined that:

- The revenue from a one-time sale of software technology rights should not be recognized,
- The revenues and cost of revenues should be presented separately as product and services revenues and corresponding costs of revenues,
- The amortization expense of software products should be reported as cost of product revenue,
- The debt discount and beneficial conversion charges should be capitalized and amortized over the term of the debt, and
- The convertible note payable to Toys should be re-classified from from equity to liabilities.

As a result, the condensed consolidated financial statement for the three and six months ended September 30, 2003 and 2002 have been restated from the amounts previously reported. A summary of the significant effects of the restatement is as follows:

	As Previously Reported	Restatem Adjustm
At September 30, 2003:		
Accounts receivable, net	$ 8,514	$ (3,
Current assets	12,118	(3,

Total assets		43,538		(3,
Convertible note		--		1,
Total liabilities		6,031		1,
Committed common stock		1,383		(1,
Additional paid-in capital		61,526		1,
Accumulated deficit		(39,506)		(5,
Total stockholders' equity		37,507		(5,
For the three-month period ended September 30, 2003:				
Total revenues	$	6,679	$	(3,
Cost of revenues		1,074		
Gross profit		5,605		(4,
Application development expense		546		
Depreciation and amortization		898		(
Total expenses		4,445		(
Interest expense		(209)		(1,
Net income (loss)		700		(5,
Net income (loss) available to common stockholders		418		(5,
Basic and diluted EPS (loss) available to common stockholders		0.01		(0
For the six-month period ended September 30, 2003:				
Total revenues	$	12,145	$	(3,
Cost of revenues		2,728		1,
Gross profit		9,417		(5,
Application development expense		683		
Depreciation and amortization		1,766		1,
Total expenses		8,246		(1,
Interest expense		(521)		(1,
Net income (loss)		984		(5,
Net income (loss) available to common stockholders		430		(5,
Basic and diluted EPS (loss) available to common stockholders		0.01		(0

1. Accounts receivables and revenues were revised to reverse recognition of revenue and receivable from a one-time sale of software technology rights in the amount of $3.9 million.

2. Convertible note and committed stock were revised to re-classify the convertible note payable to Toys in the amount of $1,383,000 to liabilities.

3. Additional paid-in capital was revised to reflect the proper amortization of debt discount and beneficial conversion interest expense, previously charged against additional paid-in capital.

4. Accumulated deficit was revised to reverse revenue of $3.9 million from a one-time sale of software technology rights and recognize amortization expense of $1,275,000 in connection with the debt discount and beneficial conversion interest charges on the March '03, April '03 and May '03 debt financings.

5. Cost of revenues was revised to include amortization of capitalized software in the amount of $579,000 and $1,162,000 in the three and six-month periods ended September 30, 2003, respectively, previously reported as depreciation and amortization expense and to re-classify $39,000 expense to application development expense.

6. Application development expense was revised to include $39,000 expense in the periods ended September 30, 2003, previously reported as cost of revenues.

7. Depreciation and amortization was revised to re-classify amortization of software in the amounts of $579,000 and $1,201,000 in the three and six-month periods ended September 30, 2003, respectively, to cost of revenues.

8. Interest expense was revised to recognize amortization expense in connection with debt discount and beneficial conversion interest charges of $1,275,000 on the March '03, April '03 and May '03 debt financings.

ITEM 2. - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934 AND THE COMPANY INTENDS THAT CERTAIN MATTER DISCUSSED IN THIS REPORT ARE "FORWARD-LOOKING STATEMENTS" INTENDED TO QUALIFY FOR THE SAFE HARBOR FROM LIABILITY ESTABLISHED BY THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. THESE FORWARD-LOOKING STATEMENTS CAN GENERALLY BE IDENTIFIED BY THE CONTEXT OF THE STATEMENT WHICH MAY INCLUDE WORDS SUCH AS THE COMPANY ("IPI", "WE" OR "US") "BELIEVES", "ANTICIPATES", "EXPECTS", "FORECASTS", "ESTIMATES" OR OTHER WORDS SIMILAR MEANING AND CONTEXT. SIMILARLY, STATEMENTS THAT DESCRIBE FUTURE PLANS, OBJECTIVES, OUTLOOKS, TARGETS, MODELS, OR GOALS ARE ALSO DEEMED FORWARD-LOOKING STATEMENTS. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE FORECASTED OR ANTICIPATED AS OF THE DATE OF THIS REPORT. CERTAIN OF SUCH RISKS AND UNCERTAINTIES ARE DESCRIBED IN CLOSE PROXIMITY TO SUCH STATEMENTS AND ELSEWHERE IN THIS REPORT INCLUDING ITEM 2, "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS." STOCKHOLDERS, POTENTIAL INVESTORS AND OTHER READERS ARE URGED TO CONSIDER THESE FACTORS IN EVALUATING THE FORWARD-LOOKING STATEMENTS AND ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON SUCH FORWARD-LOOKING STATEMENTS OR CONSTRUE SUCH STATEMENTS TO BE A REPRESENTATION BY US THAT OUR OBJECTIVES OR PLANS WILL BE ACHIEVED. THE FORWARD-LOOKING STATEMENTS INCLUDED IN THIS REPORT ARE MADE ONLY AS OF THE DATE OF THIS REPORT, AND WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE SUCH FORWARD-LOOKING STATEMENTS TO REFLECT SUBSEQUENT EVENTS OR CIRCUMSTANCES.

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES AND OTHER FINANCIAL INFORMATION APPEARING ELSEWHERE IN THIS FORM 10-Q/A. READERS ARE ALSO URGED TO CAREFULLY REVIEW AND CONSIDER THE VARIOUS DISCLOSURES MADE BY US WHICH ATTEMPT TO ADVISE INTERESTED PARTIES OF THE FACTORS WHICH AFFECT OUR BUSINESS, INCLUDING WITHOUT LIMITATION THE DISCLOSURES MADE UNDER THE CAPTION "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," AND THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED IN OUR ANNUAL

REPORT FILED ON FORM 10-K/A FOR THE YEAR ENDED MARCH 31, 2003, AND THE DISCLOSURES UNDER THE HEADING "RISK FACTORS" IN THE FORM 10-K/A, AS WELL AS OTHER REPORTS AND FILINGS MADE WITH THE SECURITIES AND EXCHANGE COMMISSION.

OVERVIEW

We are a provider of software solutions and services to the retail industry. We provide solutions that help retailers understand, create, manage and fulfill consumer demand. We derive the majority of our revenues from three sources: the initial sale of application software licenses, or license revenues, professional services and support, or maintenance services. Application software license fees are dependent upon the sales volume of our customers, the number of users of the application(s), and/or the number of locations in which the customer plans to install and utilize the application(s). As the customer grows in sales volume, adds additional users and/or adds additional locations, we charge additional license fees. Professional services relate to implementation of our software, training of customer personnel and modification or customization work. Support, maintenance and software updates are a source of recurring revenues and are generally based on a percentage of the software license revenues and are charged on an annual basis pursuant to renewable maintenance contracts. We typically charge for professional services including consulting, implementation and project management services on an hourly basis.

As the vast majority of our revenues are derived from the retail industry, we are heavily dependent on the financial strength of retailers and their capital budgets. Deterioration in the health of retailers or a reduction in their capital budget or a decision to delay the purchase of new systems have a direct impact on our business. Our sales cycles are long, generally three to twelve months, and our ability to close a pipeline of potential transaction is very unpredictable. As such, management believes that license revenue and growth in license revenue are the best indicator of the Company's business as they signify either new customers or an expansion of licenses of existing customers. While there's generally a time lag between a sale of new license and when we provide services and support, an increase in license revenue will generally lead to an increase in services and support revenues in future quarters.

RESTATEMENTS

As discussed in the notes to condensed financial statements, we restated our September 30, 2003 financial statements to:

1. Reverse recognition of revenue from a one-time sale of software technology rights,

2. Present revenues and cost of revenues separately as product and services and corresponding cost of revenues,

3. Report amortization of software products as cost of product revenue,

4. Capitalize and amortize of debt discount and beneficial conversion charge as interest expense over the term of the debt, and

5. Re-classify the convertible note payable from equity to liabilities.

These changes had no impact on the net cash flows from operations.

RECENT DEVELOPMENTS

In the third quarter of fiscal 2004, the 9% convertible debenture holders converted all of outstanding balances totaling $4.2 million into 4,103,141 shares of our common stock.

In September 2003, ICM Asset Management's investors converted all outstanding balances totaling $1.4 million of the convertible notes into 2,287,653 shares of our common stock.

In October 2003, we announced our intentions to acquire Page Digital, Inc. for $7 million. This acquisition has not yet been finalized as of the date of this report.

In October 2003, Donald Radcliffe resigned as a member of our Board Directors.

In November 2003, we entered into an agreement with various institutional investors for the sale of 3,180,645 shares of common stock at a price of $1.55 per share for an aggregate purchase price of $4.9 million. See "Liquidity and Capital Resources -- Financing Transactions" below.

DISCONTINUED OPERATIONS

Effective April 1, 2003, we sold our wholly-owned subsidiary, SVI Training Products, Inc. ("Training Products") to its former president for the sale price of $180,000 plus earn-out payments equal to 20% of the total gross revenues of Training Products in each of its next two fiscal years, to the extent the revenues in each of those years exceed certain targets. We received a promissory note for the amount of $180,000 and the earn-out payments, if any, will be made in quarterly installments following each fiscal year, bearing an annual interest rate of 5%. The sale of the Training Products subsidiary resulted in a loss of $129,000, net of estimated income taxes, which was accrued for at March 31, 2003. The operating results of Training Products for the prior periods are restated as discontinued operations.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, based on historical experience, and 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. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect significant judgments and estimates used in the preparation of our consolidated financial statements:

o REVENUE RECOGNITION. Our revenue recognition policy is significant because our revenue is a key component of our results of operations. In addition, our revenue recognition determines the timing of certain expenses such as commissions and royalties. We follow specific and detailed guidelines in measuring revenue; however, certain judgments affect the application of our revenue policy.

We license software under non-cancelable agreements and provide related services, including consulting, training, customization of software and customer support. We recognize revenue in accordance with Statement of Position 97-2 (SOP 97-2), Software Revenue Recognition, as amended and interpreted by Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, with respect to certain transactions, as well as Technical Practice Aids issued from time to time by the American Institute of Certified Public Accountants.

Software license revenue, including third party license revenues or partner products, is generally recognized when a license agreement has been signed, the software product has been delivered, there are no uncertainties surrounding product acceptance, the fees are fixed and determinable, and collection is considered probable. If a software license contains an undelivered element, the fair value of the undelivered element is deferred and the revenue recognized once the element is delivered. We can establish vendor specific objective evidence ("VSOE") for all elements and not just undelivered elements. The undeliverable elements are primarily training, consulting and maintenance services. VSOE of fair value for training and consulting services is based upon hourly rates charged when those services are sold separately. VSOE of fair value for maintenance is the price the customer will be required to pay when it is sold separately (that is, the renewal rate). In addition, if a software license contains contingencies, such as specific customer acceptance criteria, right of return or a cancellation right, the software revenue is recognized upon the later of customer acceptance or the expiration of the acceptance period or cancellation right. Typically, payments for our software licenses are due in installments within twelve months from the date of delivery. Where software license agreements call for payment terms of twelve months or more from the date of delivery, revenue is recognized as payments become due and all other conditions for revenue recognition have been satisfied. Deferred revenue consists primarily of prepaid maintenance support revenues, prepaid services revenue and deferred licenses.

Consulting services are separately priced, are generally available from a number of suppliers, and are not essential to the functionality of our software products. Consulting services, which include project management, system planning, design and implementation, customer configurations, and training are billed on both an hourly basis and under fixed price contracts. Consulting services revenue billed on an hourly basis is recognized as the work is performed. Under most fixed price contracts, consulting services revenue is recognized using the percentage of completion method of accounting by relating hours incurred to date to total estimated hours at completion. In instances where our fixed price contracts require the achievement of certain milestones, the milestones are agreed with the customer and revenues are recognized only when the milestones are delivered and accepted by the customer.

Customization of software is billed on both an hourly basis and under fixed price contracts. Customization services billed on an hourly basis are recognized as the work is performed. Under most fixed price contracts, customization services revenue is recognized using the percentage of completion method of accounting by relating hours incurred to date to total estimated hours at completion. In instances where our fixed price contracts require the achievement of certain milestones, the milestones are agreed with the customer and revenues are recognized only when the milestones are delivered and accepted by the customer.

Customer support services include post contract support and the rights to unspecified upgrades and enhancements. Maintenance revenues from ongoing customer support services are billed on a monthly basis and recorded as revenue in the applicable month, or on an annual basis with the revenue being deferred and recognized ratably over the maintenance period. If an arrangement includes multiple elements, the fees are allocated to the various elements based upon vendor-specific objective evidence of fair value.

- ACCOUNTS RECEIVABLE. We typically extend credit to our customers. Software licenses are generally due in installments within twelve months from the date of delivery. Billings for customer support and consulting services performed on a time and material basis are due upon receipt. From time to time software and consulting services are provided under fixed price contracts where the revenue is only recognized and the payments are only due upon customer acceptance and the achievement of certain milestones. Management estimates the probability of collection of the receivable balances and provides an allowance for doubtful accounts based upon an evaluation of our customers ability to pay and general economic conditions.

- VALUATION OF LONG-LIVED AND INTANGIBLE ASSETS AND GOODWILL. For fiscal 2003, we have adopted SFAS No. 142 resulting in a change in the way we value long-term intangible assets and goodwill. We completed the initial transitional analysis of goodwill impairment as of April 1, 2002 and recorded an impairment of $0.6 million as a cumulative effect of a change in accounting principle in the first quarter of fiscal 2003. We no longer amortize goodwill, but instead test goodwill for impairment on an annual basis or more frequently if certain events occur. Goodwill is to be measured for impairment by reporting units, which currently consist of our operating segments. At each impairment test for a business unit, we are required to compare the carrying value of the business unit to the fair value of the business unit. If the fair value exceeds the carrying value, goodwill will not be considered impaired. If the fair value is less than the carrying value, we will perform a second test comparing the implied fair value of reporting unit goodwill with the carrying amount of that goodwill. The difference if any between the carrying amount of that goodwill and the implied fair value will be recognized as an impairment loss, and the carrying amount of the associated goodwill will be reduced to its implied fair value. These tests require us to make estimates and assumptions concerning prices for similar assets and liabilities, if available, or estimates and assumptions for other appropriate valuation techniques.

For our intangible assets with finite lives, including our capitalized software and non-compete agreements, we assess impairment at least annually or whenever events and circumstances suggest the carrying value of an asset may not be recoverable based on the net future cash flows expected to be generated from the asset on an undiscounted basis. When we determine that the carrying value of intangibles with finite lives may not be recoverable, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

22

RECENT ACCOUNTING PRONOUNCEMENTS

A number of new pronouncements have been issued for future implementation as discussed in the footnotes to our interim financial statements (see Note 9). As discussed in the notes to the interim financial statements, the implementation of some of these new pronouncements is not expected to have a material effect on our financial position or results of operations.

THREE MONTHS ENDED SEPTEMBER 30, 2003 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2002

REVENUES

Product revenues decreased $0.2 million, or 10%, to $1.8 million in the quarter ended September 30, 2003 from $2.0 million in the quarter ended September 30, 2002, primarily due to a $0.4 million decrease in new licenses, offset by $0.2 million from the sale of partner products. Services revenues decreased by $0.8 million, or 44% to $1.0 million in the quarter ended September 30, 2003 from $1.8 million in the quarter ended September 30, 2002 primarily due to a $0.8 million decrease from Toys R Us., Inc. "(Toys"). Toys revenue in fiscal 2004 consisted primarily of implementation services. Toys had been a major customer since fiscal 2000 and terminated its contract in third quarter of fiscal 2004. As we don't anticipate additional material Toys revenue in the near future, the loss of Toys will have a significant impact on future revenues as we attempt to replace those revenues with revenues generated from new customers. Total revenues decreased $1.0 million, or 26%, to $2.8 million in the quarter ended September 30, 2003 from $3.8 million in the quarter ended September 30, 2002 due to the above factors. Excluding Toys revenues of $0.2 million and $1.0 million in the quarter ended September 30, 2003 and September 30, 2002, respectively, total revenues were $2.6 million for the quarter ended September 30, 2003 compared to $2.8 million in the quarter ended September 30, 2002, a 7% decrease.

COST OF REVENUES/GROSS PROFIT

Cost of revenues decreased by $0.6 million, or 26%, to $1.7 million in the quarter ended September 30, 2003 from $2.3 million in the quarter ended September 30, 2002. Cost of product revenues remained at $1.2 million in the quarter ended September 30, 2003 and the quarter ended September 30, 2002. Cost of services revenue decreased $0.7 million, or 58%, to $0.5 million in the quarter ended September 30, 2003 from $1.2 million in the quarter ended September 30, 2002. Total gross profit decreased $0.4 million, or 27%, to $1.1 million in the quarter ended September 30, 2003 from $1.5 million in the quarter ended September 30, 2002. Total gross profit was 39% for the quarter ended September 30, 2003 and September 30, 2002. Gross profit on products was 33% and 40% for the quarters ended September 30, 2003 and September 30, 2002, respectively, while gross profit on services was 50% and 33% for the quarters ended September 30, 2003 and September 30, 2002, respectively. Amortization of capitalized software included in cost of product revenues decreased to $0.6 million in the quarter ended September 30, 2003 from $0.7 million in the quarter ended September 30, 2002. The decrease in gross margin for product revenues is due primarily an increase in sale of partner products which carry lower margins than company licenses. The increase in gross margin on services was due primarily to a decrease, in the quarter ended September 30, 2003, of the percentage of reimbursed costs, which carry 100% costs, as a percentage of total services as well as decrease of Toys services in the quarter ended September 30, 2003, which generally carry lower margins.

APPLICATION DEVELOPMENT EXPENSE

Application development expense decreased by $0.7 million, or 54%, to $0.6 million in the quarter ended September 30, 2003 from $1.3 million in the quarter ended September 30, 2002. The decrease is primarily due to capitalizing $0.9 million development costs for new products. We've made significant investments in our new products in the current year. We anticipate these new products will be launched during the second half of the fiscal 2004. In the prior comparative period, research and development efforts was spent on enhancing existing products.

DEPRECIATION AND AMORTIZATION

Depreciation and amortization remained at $0.3 million in the quarter ended September 30, 2003 and the quarter ended September 30, 2002.

23

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses increased by $1.1 million, or 58%, to $3.0 million in the three months ended September 30, 2003 from $1.9 million in the three months ended September 30, 2002. Much of the current quarter was spent building the infrastructure and developing our sales organization.

LOSS FROM OPERATIONS

Loss from operations, which included depreciation and amortization expense, was $2.7 million for the quarter ended September 30, 2003, compared to a loss from operations of $2.1 million for the quarter ended September 30, 2002. Earnings from continuing operations before interest, provision for income taxes, depreciation, amortization and change in accounting principle was

$2.1 million for the quarter ended September 30, 2003 compared to a loss of $1.0 million for the quarter ended September 30, 2002.

INTEREST EXPENSE

Interest expense increased by $0.5 million, or 50%, to $1.5 million in the quarter ended September 30, 2003 from $1.0 million in the quarter ended September 30, 2002. The increase is due primarily to $0.6 million in amortization of debt discount and beneficial conversion charges the convertible debt.

PROVISION FOR INCOME TAXES

Provision for income taxes for the quarters ended September 30, 2003 and 2002 are $67,000 and $1,000, respectively.

CUMULATIVE PREFERRED DIVIDENDS

Cumulative dividends on the outstanding Series A Preferred attributable to the quarter ended September 30, 2003 and 2002 were $0.3 million.

SIX MONTHS ENDED SEPTEMBER 30, 2003 COMPARED TO SIX MONTHS ENDED SEPTEMBER 30, 2002

REVENUES

Product revenues increased $0.9 million, or 22%, to $5.0 million in the six months ended September 30, 2003 from $4.1 million in the six months ended September 30, 2002, primarily due to a $0.6 million increase from the sale of partner products and $0.3 million increase in new licenses. Services revenues decreased by $1.4 million, or 30% to $3.2 million in the six months ended September 30, 2003 from $4.6 million in the six months ended September 30, 2002 primarily due to a $1.6 million decrease from Toys R Us., Inc. "(Toys"). Toys revenue in fiscal 2004 consisted primarily of implementation services. Toys had been a major customer since fiscal 2000 and terminated its contract in third quarter of fiscal 2004. As we don't anticipate additional material Toys revenue in the near future, the loss of Toys will have a significant impact on future revenues as we attempt to replace those revenues with revenues generated from new customers. Total revenues decreased $0.5 million, or 6%, to $8.2 million in the six months ended September 30, 2003 from $8.7 million in the six months ended September 30, 2002 due to the above factors. Excluding Toys revenues of $1.5 million and $3.1 million in the six months ended September 30, 2003 and September 30, 2002, respectively, total revenues were $6.7 million for the six months ended September 30, 2003 compared to $5.6 million in the six months ended September 30, 2002, a 20% increase.

COST OF REVENUES/GROSS PROFIT

Cost of revenues decreased by $1.2 million, or 24%, to $3.9 million in the six months ended September 30, 2003 from $5.1 million in the six months ended September 30, 2002. Cost of product revenues increased by $0.1 million, or 4%, to $2.4 million in the six months ended September 30, 2003 from $2.3 million in the six months ended September 30, 2002. Cost of services revenue decreased $1.3 million, or 46%, to $1.5 million in the six months ended September 30, 2003 from $2.8 million in the six months ended September 30, 2002. Total gross profit increased $0.8 million, or 22%, to $4.4 million in the six months ended September 30, 2003 from $3.6 million in the six months ended September 30, 2002. Total gross profit was 54% and 41% for the six months ended September 30, 2003 and September 30, 2002. Gross profit on products was 54% and 44% for the six months ended September 30, 2003 and September 30, 2002, respectively, while gross profit on services was 53% and 39% for the six months ended September 30, 2003 and September 30, 2002, respectively. Amortization of capitalized software included in cost of product revenues decreased to $1.2 million in the six months ended September 30, 2003 from $1.5 million in the six months ended September 30, 2002. The increase in gross margin for product revenues is due primarily to a $0.3 million increase in company licenses and a $0.3 million reduction in amortization of capitalized software costs in the six months ended September 30, 2003 compared to the six months ended September 30, 2002. The increase in gross margin on services was due primarily to a decrease of the percentage of reimbursed costs, which carry 100% costs, as a percentage of total services as well as decrease of Toys services in the quarter ended September 30, 2003, which generally carry lower margins. Reimbursed costs represented approximately 4% of total services revenues in the six months ended September 30, 2003 compared to 10% in the six months ended September 30, 2002.

APPLICATION DEVELOPMENT EXPENSE

Application development expense decreased by $1.5 million, or 68%, to $0.7 million in the six months ended September 30, 2003 from $2.2 million in the six months ended September 30, 2002. The decrease is primarily due to capitalizing $1.8 million development costs for new products. We've made significant investments in our new products in the first six months of the current quarter. We anticipate these new products will be launched during the second half of the fiscal 2004. In the prior comparative period, research and development efforts was spent on enhancing existing products.

DEPRECIATION AND AMORTIZATION

Depreciation and amortization remained at $0.6 million in the six months ended September 30, 2003 and the six months ended September 30, 2002.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses increased by $2.0 million, or 53%, to $5.8 million in the six months ended September 30, 2003 from $3.8 million in the six months ended September 30, 2002. The first six months of fiscal 2003 included a $0.6 million reversal of excess amount accrued in prior periods for a litigation settlement. Additional, much of the first six months of fiscal 2004 was spent building the infrastructure and developing our sales organization.

LOSS FROM OPERATIONS

Loss from operations, which included depreciation and amortization expense, was $2.7 million for the six months ended September 30, 2003, compared to a loss from operations of $3.1 million for the comparable period in prior year.

INTEREST EXPENSE

Interest expense increased by $0.4 million, or 29%, to $1.8 million in the six months ended September 30, 2003 from $1.4 million in the six months ended September 30, 2002. The increase is due primarily to $0.7 million increase in amortization of debt discount and beneficial conversion, offset by $0.3 million decrease in interest expense.

PROVISION FOR INCOME TAXES

Provision for income taxes represents $0.6 million income tax refund and $0.1

million provision for state income taxes in the six months ended September 30, 2003. No provision was made at in the six months ended September 30, 2002 due to the availability of tax losses. The income tax refund of $0.6 million at September 30, 2003 results from amending prior years' income tax returns to carry back net operating losses incurred in the past 2 years.

CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE

Pursuant to SFAS 142, we completed the transitional analysis of goodwill impairment as of April 1, 2002 and recorded an impairment of $0.6 million as the cumulative effect of a change in accounting principle in the quarter ended June 30, 2002. We also evaluated the remaining useful lives of our intangibles in the quarter ended June 30, 2002 and no adjustments have been made to the useful lives of our intangible assets. There have been no such charges in the quarter ended June 30, 2003.

CUMULATIVE PREFERRED DIVIDENDS

Cumulative dividends on the outstanding Series A Preferred attributable to the six months ended September 30, 2003 and 2002 were $0.6 million and $0.5 million, respectively.

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOWS

During the six months ended September 30, 2003, we financed our operations using cash on hand, internally generated cash, proceeds from the sale of common stock and proceeds from sale of convertible debentures. At September 30, 2003 and March 31, 2003, we had cash of $1.1 million and $1.3 million, respectively.

Operating activities used cash of $5.6 million in the six months ended September 30, 2003 and $1.9 million in the six months ended September 30, 2002. Cash used for operating activities in the six months ended September 30, 2003 resulted from $4.2 million net loss, $0.6 million increase in accounts receivable and other receivables and $3.9 million decrease in accounts payable and accrued expenses; offset in part by $1.8 million of non-cash depreciation and amortization and $1.5 million amortization of debt discount and conversion option.

Investing activities used cash of $2.5 million in the six months ended September 30, 2003 and $0.3 million in the six months ended September 30, 2002. Cash used for investing activities in the current quarter was primarily for capitalization of $2.2 million software development costs.

Financing activities provided cash of $7.8 million and $1.0 million in the six months ended September 30, 2003 and 2002, respectively. The 2004 financing activities included net proceeds of $7.2 million from the sale of common stock and $0.7 million from the issuance of convertible debentures.

Accounts receivable increased to $4.6 million at September 30, 2003 from $4.0 million at March 31, 2003. The increase is primarily due to $3.9 million in current receivable from new sales.

We believe that our cash and cash equivalent and funds generated from operations will provide adequate liquidity to meet our normal operating requirements for at least the next twelve months. Our future capital requirements depend on many factors, including our application development and sales and marketing activities. In addition, we have incurred losses for the last three fiscal years. In the next twelve months, we anticipate raising additional capital through public or private equity or debt financings. In the long-term, we anticipate that cash from operations will be sufficient to provide liquidity for our normal operating requirements. As such, we do not know whether additional financing will be available when needed, or available on terms acceptable to us. We may raise capital through public or private equity or debt financings. If we are unable to raise the needed funds, we may be forced to curtail some or all of our activities and we may not be able to grow.

FINANCING TRANSACTIONS

In June 2003, we entered into an agreement with various institutional investors ("June 2003 Institutional Investors") for the sale to these investors of 5,275,000 shares of common stock at a per share price of $1.50 for an aggregate purchase price of $7.9 million. Pursuant to a registration rights agreement, we filed a separate registration statement respecting their shares which was declared effective on September 26, 2003 by the SEC.

In connection with this financing, we paid Roth Capital Partners, LLC, as placement agent, cash compensation of 8% of the proceeds and issued a warrant to purchase 527,500 shares of common stock at an exercise price of $1.65 per share. We also issued warrants to purchase 375,000 shares of common stock at an exercise price of $1.65 to certain holders of our 9% convertible debentures in order to obtain their requisite consents and waivers of rights they possessed to participate in the financing.

On November 7, 2003, we entered into an agreement with various institutional investors ("November 2003 Institutional Investors") for the sale of 3,180,645 shares of common stock at a price of $1.55 per share for an aggregate purchase price of $4.9 million. We also granted the November 2003 Institutional Investors registration rights under a registration rights agreement in which we agree to file a registration statement with the Securities and Exchange Commission for the resale of all shares sold these investors. If the registration statement is not filed by December 7, 2003, we will be obligated to pay on December 7, 2003, and each monthly anniversary until the registration statement is filed, an amount in cash, as liquidated damages, equal to 2.0% of the purchase price paid by the November 2003 Institutional Investors.

In connection with this financing, we paid Roth Capital Partners, LLC ("Roth Capital"), as placement agent, a compensation of $179,000 in cash and 115,226 shares of our common stock and issued a five-year warrant to purchase 282,065 shares of our common stock at an exercise price of $1.71 per share. Roth Capital was granted the registration rights similar to those granted to the November 2003 Institutional Investors.

INDEBTEDNESS

UNION BANK

Pursuant to the Discounted Loan Payoff Agreement dated March 31, 2003, we issued to Union Bank of California a $500,000 unsecured, non-interest bearing convertible note payable in either cash or shares of common stock, at our option. If we elect to pay the principal amount or any portion thereof in shares of common stock, the shares will be computed on a price per share of 80% of the average share closing price of our common stock for the ten trading day period immediately preceding payoff date. The maturity date is March 31, 2004. As of September 30, 2003, the bank had assigned the right of this note to Roth Capital Partners, LLC.

NATIONAL AUSTRALIA BANK LIMITED

We decided in the third quarter of fiscal 2002 to sell certain assets of the Australian subsidiary to the former management of such subsidiary, and then cease Australian operations. Such sale was however subject to the approval of National Australia Bank, the subsidiary's secured lender. The bank did not approve the sale and the subsidiary ceased operations in February 2002. The bank caused a receiver to be appointed in February 2002 to sell substantially all of the assets of the Australian subsidiary and pursue collections on any outstanding receivables. The receiver proceeded to sell substantially all of the assets for $300,000 in May 2002 to the entity affiliated with former management, and is actively pursuing the collection of receivables. If the sale proceeds plus collections on receivables are insufficient to discharge the indebtedness to National Australia Bank, we may be called upon to pay the deficiency under our guarantee to the bank. At June 30, 2002, we have accrued $187,000 as the maximum amount of our potential exposure. The receiver has also claimed that we are obligated to it for inter-company balances of $636,000, but we do not believe any amounts are owed to the receiver, who has not as of the date of this report acknowledged the monthly corporate overhead recovery fees and other amounts charged by us to the Australian subsidiary offsetting the amount claimed to be due.

ICM ASSET MANAGEMENT, INC.

During the quarter ended June 30, 2001, we entered into Subscription Agreements with a limited number of accredited investors related to existing stockholders for gross proceeds of $1.3 million. Each unit consisted of a convertible promissory note to purchase 250 shares of our common stock for each $1,000 borrowed by us. The holders of the notes had the option to convert the unpaid principal and interest to common stock at any time at a conversion price of $0.60 per share. The notes matured on September 30, 2003 and earned interest at 8% per annum, increasing to 13% in the event of a default in payment of principal or interest, to be paid at maturity. We did not have a right to prepay the notes. In September 2003, the investors converted the outstanding balance of principal and accrued interest totaling $1.4 million into 2,287,653 shares of our common stock.

We also issued to these accredited investors warrants to purchase an aggregate of 1,600,000 shares at $0.60 per share, expiring July 19, 2007. The warrants are not callable by us. No warrants have been exercised as of October 31, 2003.

We filed a registration statement for the resale of all shares held by or obtainable by these and other investors. The registration statement was declared effective by the SEC on July 18, 2003.

TOYS "R" US

In May 2002, Toys "R" Us, Inc. ("Toys") agreed to invest $1.3 million for the purchase of a non-recourse convertible note and a warrant to purchase 2,500,000 common shares. The purchase price was received in installments through September 27, 2002. The note is non-interest bearing, and the face amount was either convertible into shares of our stock valued at $0.553 per share or payable in cash at our option, at the end of the term. In November 2002, the Board decided that this note will be converted solely for equity and will not be repaid in cash. The note is due May 29, 2009, or if earlier than that date, three years after the completion of the development project contemplated in the development agreement between us and Toys entered into at the same time. We do not have the right to prepay the convertible note before the due date. The face amount of the note is 16% of the $1.3 million purchase price as of May 29, 2002, and increases by 4% of the $1.3 million purchase price on the last day of each succeeding month, until February 28, 2004, when the face amount is the full $1.3 million purchase price. The face amount will cease to increase if Toys terminates its development agreement with us for a reason other than our breach. The face amount will be zero if we terminate the development agreement due to an uncured breach by Toys of the development agreement. We have received all of the $1.3 million proceeds.

The warrant entitles Toys to purchase up to 2,500,000 of our common shares at $0.553 per share. The warrant was initially vested as to 400,000 shares as of May 29, 2002, and vests at the rate of 100,000 shares per month until February 28, 2004. The warrant will cease to vest if Toys terminates its development agreement with us for a reason other than our breach. The warrant will become entirely non-exercisable if we terminate the development agreement due to an uncured breach by Toys of the development agreement. Toys may elect a "cashless exercise" where a portion of the warrant is surrendered to pay the exercise price. As of October 31, 2003, 2.1 million shares of the warrant are exercisable. No warrants have currently been exercised.

The note conversion price and the warrant exercise price are each subject to a 10% reduction in the event of an uncured breach by us of certain covenants to Toys. These covenants do not include financial covenants. Conversion of the note and exercise of the warrant each require 75 days advance notice. As a result, under the rules of the SEC, Toys will not be considered the beneficial owner of the common shares into which the note is convertible and the warrant is exercisable until 15 days after it has given notice of conversion or exercise, and then only to the extent of such noticed conversion or exercise. We also granted Toys certain registration rights for the common shares into which the note is convertible and the warrant is exercisable, including the right to demand registration on Form S-3 if such form is available to us, and the right to include shares into which the note is convertible and the warrant is exercisable in other registration statements we propose to file.

OMICRON/MIDSUMMER/ISLANDIA

On March 31, 2003, we entered into a securities purchase agreement with Midsummer Investment, Ltd. ("Midsummer"), Omicron Master Trust ("Omicron"), and Islandia, L.P. ("Islandia") for the sale to these investors of debentures, convertible into shares of our common stock at a conversion price equal to $1.0236 per share, for an aggregate amount of $3.5 million. The investors also received a five-year warrant to purchase up to, in the aggregate, 1,572,858 shares of common stock with an exercise price equal to $1.0236 per share. The debentures would have been matured in May 2005 and bore an interest rate of 9% per annum. Interest was payable on a quarterly basis commencing on June 1, 2003, in cash or shares of common stock, at our option. If certain conditions were met, we had the right, but not the obligation, to redeem the debentures at 110% of their face value, plus accrued interest. Commencing in February 2004, we would have been obligated to redeem $219,000 per month of the debentures. Furthermore, if the daily volume weighted average price of our common stock on the American Stock Exchange exceeds $1.0236 by more than 200% for 15 consecutive trading days, we will have the option to cause the investors to convert their debentures into common stock. In July 2003, Omicron converted $500,000 of their debenture into 488,472 shares of our common stock. In August 2003, the daily volume weighted average price of our common stock on the American Stock Exchange exceeded $1.02 by more than 200% for 15 consecutive trading days; therefore, we exercised the option to cause the investors to convert their debentures into common stock. As a result, the investors converted the remaining balance of their debentures into an aggregate of 2,930,832 shares of our common stock as of September 30, 2003.

Pursuant to the registration rights agreement, we filed a registration statement covering 130% of the common stock issuable upon the conversion of the debentures and the warrants. The registration statement was declared effective July 18, 2003.

Additional debentures, aggregating up to $2 million, will be sold to these investors in a second closing, if within one year after the date of first sale of debentures there occurs a period of 15 consecutive trading days during which the daily volume weighted average closing price of our common stock is maintained at a price at or above $1.75 per share, subject to certain conditions. The shares of common stock underlying these debentures and warrants were not included in the registration statement declared effective in July 2003. Neither the investors nor we have executed the second closing as of October 31, 2003.

28

MBSJ INVESTORS, LLC

On April 1, 2003, we entered into a securities purchase agreement with MBSJ Investors, LLC ("MBSJ") for the sale to MBSJ of a 9% debenture, convertible to shares of our common stock at a conversion price of $1.0236, for $400,000. This debenture was accompanied by a five-year warrant to purchase 156,311 shares of common stock with an exercise price of $1.0236 per share. Interest was due on a quarterly basis, payable in cash or shares of common stock at our option. Commencing on February 1, 2004, we would have been obligated to redeem $20,000 per month of the debenture. The debenture wenter">6.90
4.75

April 1, 2011 to June 30, 2011
5.98
4.33

July 1, 2011 to September 30, 2011
5.50
3.31

October 1, 2011 to December 31, 2011
5.72
3.80

January 1, 2012 to March 31, 2012
5.05
4.36

April 1, 2012 to June 30, 2012
5.09
4.49

```
July 1, 2012 to September 30, 2012
 5.50
 4.46

October 1, 2012 to December 31, 2012
 5.25
 4.16
```

As of December 31, 2012 there were approximately 38 holders of record of the Company’s Common Stock. The Company’s total number of beneficial owners of common stock of the Company is approximately 570.

During 2011, the Company declared and paid dividends of five cents ($0.05) per share on the Company’s outstanding common stock to shareholders of record on July 18, 2011. The total amount of the dividends paid on July 28, 2011 was $158,000. Under the terms of the Company’s current loan agreements, the amount of dividends is limited by the terms of the financial covenants.

Item No. 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company produces film products for novelty, packaging and container and custom product applications. These products include foil balloons, latex balloons and related latex toy products, films for packaging applications, flexible containers for packaging and storage applications and custom film products. We produce all of our film products for packaging and container applications at our facilities in Lake Barrington, Illinois. We produce all of our latex balloons and latex products at our facility in Guadalajara, Mexico. Substantially all of our film products for packaging applications and flexible containers for packaging and storage are sold to customers in the United States. We market and sell our novelty items – principally foil balloons and latex balloons – in the United States, Mexico, the United Kingdom and a number of additional countries.

Our revenues from each of our product categories in each of the past two years have been as follows:

	(000 Omitted)			
	$	% of	$	% of
Product Category	2012	Net Sales	2011	Net Sales
Metalized Balloons	22,296	45.0%	21,443	45.4%
Latex Balloons	11,129	22.5%	10,202	21.7%
Pouches	9,475	19.1%	8,311	17.6%
Film Products	4,913	9.9%	6,259	13.3%
Other	1,730	3.5%	956	2.0%
Total	49,543	100.0%	47,171	100.0%

Our primary expenses include the cost of products sold and selling, general and administrative expenses.

Cost of products sold primarily consists of expenses related to raw materials, labor, quality control and overhead expenses such as supervisory labor, depreciation, utilities expense and facilities expense directly associated with production of our products, as well as shipping costs relating to the shipment of products to customers. Cost of products sold is impacted by the cost of the raw materials used in our products, the cost of shipping, along with our efficiency in managing the production of our products.

Selling, general and administrative expenses include the compensation and benefits paid to our employees, all other selling expenses, marketing, promotional expenses, travel and other corporate administrative expenses. These other corporate administrative expenses include professional fees, depreciation of equipment and facilities utilized in administration, occupancy costs, communication costs and other similar operating expenses. Selling, general and administrative expenses can be affected by a number of factors, including staffing levels and the cost of providing competitive salaries and benefits, the cost of regulatory compliance and other administrative costs.

Purchases by a limited number of customers represent a significant portion of our total revenues. In 2012, sales to our top 10 customers represented 64.7% of net revenues. During 2012, there was one customer to whom our sales represented more than 10% of net revenues. Our principal customer sales for 2012 and 2011 were:

17

Customer	Product	2012 Sales	% of 2012 Revenues	2011 Sales	% of 2011 Revenues
Dollar Tree Stores	Balloons	$13,038,000	26.3%	$13,584,000	28.8%
Rapak, L.L.C	Films	$4,433,000	8.9%	$5,773,000	12.2%

The loss of one or more of these principal customers, or a significant reduction in purchases by one or more of them, could have a material adverse effect on our business.

Except as previously described (see page 9), we generally do not have agreements with our customers under which customers are obligated to purchase any specific or minimum amount of product from us.

Results of Operations

The following table sets forth selected results of our operations expressed as a percentage of net sales for the years ended December 31, 2012 and 2011. Our results of operations for the periods described below are not necessarily indicative of results of operations for future periods.

	Year ended December 31, 2012	2011
Net sales	100.0%	100.0%
Costs and expenses:		
Cost of products sold	78.0	80.5
Operating Expenses	19.9	16.5
Income from operations	2.1	3.0
Interest expense	(2.0)	(1.7)
Other income	0.1	0.0
Income before income taxes	0.2	1.5
Provision for income taxes	0.1	0.7
Net profit	0.2%	1.0%

Year Ended December 31, 2012 Compared to Year Ended December 31, 2011

Net Sales

For the fiscal year ended December 31, 2012, consolidated net sales from the sale of all products were $49,543,000 compared to consolidated net sales of $47,171,000 for the year ended December 31, 2011, an increase of 5.0%.

18

Sales of foil balloons were $21,443,000 in 2011 and $22,296,000 in 2012, an increase of 4.0%. Of our total foil balloon sales in 2012, $12,481,000 were to Dollar Tree. The remaining sales were made to over 500 customers including distributors and retail stores or chains in the United States, Mexico, the United Kingdom, Europe and Latin America. Sales to these other customers increased from $8,278,000 in 2011 to $9,815,000 in 2012.

Sales of latex balloons were $10,202,000 in 2011 and $11,129,000 in 2012, an increase of 9.1%. The increase is attributable to an increase in latex sales to a variety of customers in the United States, Mexico and Latin America.

Sales of pouch products were $8,311,000 in 2011 and $9,475,000 in 2012, an increase of 14.0%. Virtually all of our pouch sales in 2011 and 2012 have been of vacuumable pouches in two categories: (i) zippered pouches and (ii) open-top pouches or rolls. For the 2012 and 2011, sales of pouch products in these categories have been as follows:

	(000 Omitted)	
Pouches	2012	2011
Zippered	3,899	4,705
Open-Top or Rolls	5,576	3,606
Total	9,475	8,311

As the chart indicates above, our sales of open-top pouches and rolls increased from $3,606,000 in 2011 to $5,576,000 in 2012. These sales amounts for 2012 include sales of vacuum sealing machines as well as of the open-top pouches and rolls. Also, while most of the sales shown 2012 relate to sales of our branded line, they also include some sales of our Universal or private label lines of pouches.

Sales of film products were $6,259,000 in 2011 and $4,913,000 in 2012, a decrease of 21.5%. This decrease includes a decrease in sales to Rapak, L.L.C. of $1,340,000. In addition to Rapak, film sales included sales to 12 other customers.

Cost of Sales

Cost of sales decreased from 80.5% of sales in 2011 to 78.0% of sales in 2012. Several factors affected this improvement in our margin rates: (i) the cost of certain raw materials declined in 2012 compared to 2011, principally latex; in 2011 our average cost per kilo of latex was $5.07; in 2012, the average cost per kilo was $3.94; in addition, we enjoyed some decline in the cost of polyethylene in this period; (ii) our mix of products sold changed, particularly a decline in the sale of laminated films and an increase in the sale of pouches and, (iii) the increase in the volume of sales of foil balloons and pouches produced resulted in a decline in the unit cost of those items.

General and Administrative Expenses

General and administrative expenses increased from $5,279,000 in 2011 or 11.2% of net sales to $6,357,000 or 12.8% of net sales in 2012. The increase in general and administrative expenses is attributable to (i) an increase in salary expense in the U.S. of $203,000, (ii) an increase in legal expenses of $66,000, (iii) an increase in travel expenses of $40,000, (iv) an increase in administrative expenses at Flexo Universal of $388,000, (v) an increase in administrative expenses at CTI Europe of $100,000, and (vi) an increase in administrative expenses of $51,000 at CTI Balloons.

Selling

Selling expenses increased from $911,000 or 1.9% of sales in 2011 to $1,721,000 or 3.5% of sales in 2012. The increase in selling expenses is attributable principally to (i) an increase in salary expense of $167,000, (ii) an increase in travel expenses of $70,000, (iii) an increase in outside services of $442,000, (iv) an increase in engineering and testing services related to the vacuum sealer machines of $73,000 and (v) an increase in royalty expenses of $94,000. The increase in services expense relates to personnel, facilities and operating cost of a consulting and services firm which provided services to us in connection with planning, start-up, sourcing, marketing and selling activities for our line of branded vacuum machines and pouches.

Advertising and Marketing

Advertising and marketing expenses increased from $1,579,000 or 3.3% of sales in 2011 to $1,769,000 or 3.6% of sales in 2012. The increase in advertising and marketing expense is attributable to (i) an increase in commission expense of $180,000 related to the sale of pouch products and (ii) an increase in artwork and films for creative designs of $86,000.

Other Income or Expense

During 2012, we incurred net interest expense of $991,000 compared to net interest expense of $773,000 during 2011. The increase in interest expense is attributable to interest accrued on a Note and Warrant Purchase Agreement among the Company and BMO Private Equity (U.S.), Inc. (“BMO Equity”) under which BMO Equity loaned the sum of $5 million to the Company in July, 2012.

During 2012, we realized a foreign currency gain in the amount of $295,000 compared to foreign currency gain in 2011 of $38,000.

Net Income or Loss

During 2012, we had net income of $102,000 on a consolidated basis compared to net income of $484,000 in 2011.

Income Taxes

In 2012, the Company recognized income tax expense, on a consolidated basis, of $46,000. This income tax expense is composed of an income tax benefit in the United States of $113,000, an income tax expense realized by CTI Balloons, our United Kingdom subsidiary, in the amount of $42,000, an income tax benefit realized by CTI Europe, our Germany subsidiary, in the amount of $126,000 and an income tax expense by Flexo Universal, our Mexico subsidiary, in the amount of $243,000. In 2011, the Company recognized income tax expense, on a consolidated basis, of $319,000. This income tax expense is composed of an income tax expense in the United States of $244,000, an income tax benefit realized by CTI Balloons, our United Kingdom subsidiary, in the amount of $54,000, an income tax benefit realized by CTI Europe, our Germany subsidiary, in the amount of $156,000 and an income tax expense by Flexo Universal, our Mexico subsidiary, in the amount of $285,000.

Financial Condition, Liquidity and Capital Resources

Cash Flow Provided by Operating Activities During fiscal 2012, cash used in operating activities amounted to $2,100,000, compared to cash flow provided by operating activities during fiscal 2011 of $818,000. Significant changes in working capital items affecting cash flow provided by operating activities were:

- Depreciation and amortization of $1,728,000
- An increase in net inventory of $2,498,000
- An increase in accounts receivable of $536,000
- An increase in prepaid expenses and other assets of $456,000
- A decrease in trade payables of $1,003,000
- An increase in accrued liabilities of $634,000

We anticipate an increase in net inventory and in accounts receivable during 2013 in amounts aggregating approximately $2 million.

Cash Used in Investing Activities During fiscal 2012, cash used in investing activities amounted to $1,212,000 compared to cash used in investing activities during fiscal 2011 of $1,107,000. Cash used in investing activities was principally for maintenance expenditures and for the purchase of production equipment. We anticipate that cash used in investing activities during 2013 will be approximately the same as in 2012.

Cash Provided by Financing Activities During fiscal 2012, cash provided by financing activities amounted to $3,305,000, compared to cash used in financing activities of $135,000 during fiscal 2011. During 2012, financing activities included proceeds from issuance of long-term debt of $5,006,000, repayment of long-term debt of $854,000 and reduction of the amount outstanding under our revolving line of credit by $1,055,000.

On April 29, 2010, we entered into a Credit Agreement and associated documents with Harris N.A. , now BMO Harris Bank, N.A. ("BMO Harris") under which BMO Harris agreed to extend to the Company a credit facility in the aggregate amount of $14,417,000. The facility included (i) a Revolving Credit providing for maximum advances to the Company, and letters of credit, based upon the level of availability measured by levels of eligible receivables and inventory of the Company of $9,000,000, (ii) an Equipment Loan of up to $2,500,000 providing for loans for the purchase of equipment, (iii) a Mortgage Loan of $2,333,350, and (iv) a Term Loan in the amount of $583,333. The amount we can borrow on the Revolving Credit includes 85% of eligible accounts and 60% of eligible inventory (up to a maximum of $9,000,000). The Mortgage Loan is amortized over a term of 25 years. The maturity date of the facility was April 30, 2013.

Certain terms of the loan agreement, as amended, include:

- *Restrictive Covenants*: The Loan Agreement includes several restrictive covenants under which we are prohibited from, or restricted in our ability to:
  - Borrow money;
  - Pay dividends and make distributions;
  - Make certain investments;
  - Use assets as security in other transactions;
  - Create liens;
  - Enter into affiliate transactions;
  - Merge or consolidate; or
  - Transfer and sell assets.

- *Financial Covenants*: The Loan Agreement includes a series of financial covenants we are required to meet including:
  - We are required to maintain a tangible net worth (plus Subordinated Debt) in excess of $7,100,000 plus 50% of cumulative net income of the Company after January 1, 2010;
  - We are required to maintain specified ratios of senior debt to EBITDA on an annual basis and determined quarterly; and,
  - We are required to maintain a level of adjusted EBITDA to fixed charges on an annual basis determined quarterly of not less than 1.1 to 1. Adjusted EBITDA is EBITDA minus (i) taxes paid, (ii) dividends paid, (iii) payments for the purchase or redemption of stock, and (iv) unfunded capital expenditures.

The loan agreement provides for interest at varying rates in excess of the prime rate, depending on the level of senior debt to EBITDA over time. The initial interest rate under the loan was 4.00% per annum. On a quarterly basis, this ratio will be measured and the interest rate changed in accordance to the table below.

When Senior Debt to EBITDA is:	The Premium to the Prime Rate is:	
Greater than or equal to 3.25 to 1.00	1.25	%
Greater than or equal to 2.25 to 1.00; Less than 3.25 to 1.00	0.75	%
Less than or equal to 2.25 to 1.00	0.50	%

At December 31, 2012 the Company was paying the premium of 0.75% over prime.

On July 1, 2011, we entered into an interest rate swap agreement with BMO Capital Markets with respect to $6,780,000 of our loan balances with BMO Harris. This swap agreement limits the Company's exposure to interest rate fluctuations on the Company's floating rate loans. The swap agreement has the effect of fixing the interest rate on the loan balances covered by the swap at 4.65% per annum. The swap agreement has not been designated as a hedge for accounting purposes and we determine and record the fair value of the swap agreement each quarter. This value is recorded on the balance sheet of the Company and the amount of the unrealized gain or loss for each period is recorded as interest income or expense on the statement of operations.

On July 17, 2012, the Company entered into Amendment Number 3 to the Credit Agreement among the Company and BMO Harris pursuant to which (i) the amount of the loan commitment on the revolver loan of BMO Harris was increased from $9 million to $12 million, (ii) BMO Harris consented to a transaction among the Company and BMO Equity and (iii) the term of credit and loans to the Company provided in the Credit Agreement and BMO Harris was extended to July 17, 2017.

Also, on July 17, 2012, the Company entered into a Note and Warrant Purchase Agreement with BMO Equity pursuant to which (i) BMO Equity advanced to the Company the sum of $5 million and (ii) the Company issued to BMO Equity a warrant to purchase up to Four Percent (4%) of the outstanding shares of common stock of the Company on a fully-diluted basis (140,048 shares of common stock of the Company) at the price of One Cent ($0.01) per share. The term of the loan provided for in this Agreement is five and a half years. Interest is payable on the outstanding balance of the loan at the rate of 11.5% per annum.

The Note and Warrant Purchase Agreement includes provisions for:

(i) a closing fee of $100,000

(ii) payment of the principal amount in five and a half years with optional prepayment subject to certain prepayment premiums;

(iii) security for the note obligations in all assets of the Company junior to the security interest of BMO Harris;

(iv) various representations and warranties and covenants of the Company;

(v) financial covenants including an applicable senior leverage ratio, fixed charge coverage ratio and tangible net worth amount.

Management believes that the funds provided by this new financing arrangement as well as internally generated funds will be sufficient for the Company to meet its working capital needs for at least the next 12 months.

As of December 31, 2012, the Company was not in compliance with two financial covenants provided in the Loan Agreement and one in the Note and Warrant Purchase Agreement. BMO Harris and BMO Equity have each executed waivers of such non-compliance by the Company.

Current Assets. As of December 31, 2012, the total current assets of the Company were $27,130,000, compared to total current assets of $23,301,000 at December 31, 2011. The change in current assets reflects, principally, (i) an increase in net inventories of $2,475,000, (ii) an increase in accounts receivable of $682,000, (iii) an increase in the net deferred income tax asset of $86,000, and (iv) an increase in prepaid expenses and other current assets of $573,000.

Current Liabilities. Total current liabilities decreased from $17,689,000 as of December 31, 2011 to $16,963,000 as of December 31, 2012. Accrued other liabilities includes $154,000 in payroll accruals. Changes in current liabilities included: (i) a decrease in $651,000 in trade payables, (ii) a decrease of the line of credit of $1,044,000, and (iii) an increase in accrued and other liabilities in the amount of $915,000.

Liquidity and Capital Resources; *Working Capital.* As of December 31, 2012, our current assets exceeded our current liabilities by $10,166,000, we had cash and cash equivalents of $351,000 and there was available under our line of credit up to $3,600,000 in additional funds. Management believes that these available funds, our internally generated funds and the borrowing capacity under our revolving line of credit facility will be sufficient to meet working capital requirements for the remainder of 2013.

CTI Industries Corporation Stockholders' Equity. Stockholders' equity was $12,243,000 as of December 31, 2012 compared to $11,861,000 as of December 31, 2011.

Seasonality

In the foil balloon product line, sales have historically been seasonal with approximately 40% occurring in the period from December through March of the succeeding year and 24% being generated in the period July through October in recent years. The sale of latex balloons, pouches and laminated film products have not historically been seasonal, and as sales in these products lines have increased as a percentage of total sales, the seasonality of the Company's total net sales has decreased.

24

Critical Accounting Policies

The financial statements of the Company are based on the selection and application of significant accounting policies which require management to make various estimates and assumptions. The following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operation.

Revenue Recognition. Substantially all of the Company's revenues are derived from the sale of products. With respect to the sale of products, revenue from a transaction is recognized when (i) a definitive arrangement exists for the sale of the product, (ii) delivery of the product has occurred, (iii) the price to the buyer has been fixed or is determinable, and (iv) collectibility is reasonably assured. The Company generally recognizes revenue for the sale of products when the products have been shipped and invoiced. In some cases, product is provided on consignment to customers. In those cases, revenue is recognized when the customer reports a sale of the product.

Allowance for Doubtful Accounts. We estimate our allowance for doubtful accounts based on an analysis of specific accounts, an analysis of historical trends, payment and write-off histories. Our credit risks are continually reviewed and management believes that adequate provisions have been made for doubtful accounts. However, unexpected changes in the financial condition of customers or changes in the state of the economy could result in write-offs which exceed estimates and negatively impact our financial results.

Inventory Valuation. Inventories are stated at the lower of cost or market. Cost is determined using standard costs which approximate costing determined on a first-in, first out basis. Standard costs are reviewed and adjusted at the time of introduction of a new product or design, periodically and at year-end based on actual direct and indirect production costs. On a periodic basis, the Company reviews its inventory levels for estimated obsolescence or unmarketable items, in reference to future demand requirements and shelf life of the products. As of December 31, 2012, the Company had established a reserve for obsolescence, marketability or excess quantities with respect to inventory in the aggregate amount of $636,000. As of December 31, 2011, the amount of the reserve was $384,000. In addition, on a periodic basis, the Company disposes of inventory deemed to be obsolete or unsaleable and, at such time, records an expense for the value of such inventory. We record freight income as a component of net sales and record freight costs as a component of cost of goods sold.

Valuation of Long-Lived Assets. We evaluate whether events or circumstances have occurred which indicate that the carrying amounts of long-lived assets (principally property and equipment and goodwill) may be impaired or not recoverable. Significant factors which may trigger an impairment review include: changes in business strategy, market conditions, the manner of use of an asset, underperformance relative to historical or expected future operating results, and negative industry or economic trends. We apply the provisions of GAAP USA under which goodwill is evaluated at least annually for impairment. We conducted a qualitative assessment of our goodwill in our Mexico subsidiary for the year ended December 31, 2012 and 2011. We performed a quantitative assessment for the year ended December

31, 2011 in which we considered the assets and liabilities of the subsidiary, both recognized and unrecognized, as well as the cash flows necessary to operate the business relating to the assets and liabilities. From this quantitative assessment and from the qualitative assessment for December 31, 2012, we determined the fair value of the subsidiary exceeds the carrying amount initially recorded on December 31, 2006, and were therefore not impaired.

Foreign Currency Translation. All balance sheet accounts are translated using the exchange rates in effect at the balance sheet date. Statements of operations amounts are translated using the average exchange rates for the year-to-date periods. The gains and losses resulting from the changes in exchange rates during the period have been reported in other comprehensive income or loss, except that, on November 30, 2012, the Company determined that it does have an expectation of receiving payment with respect to indebtedness of Flexo to the Company, and accordingly, as and after that date foreign currency gains and losses with respect to such indebtedness will be reported in the statement of operations.

Stock-Based Compensation. We follow GAAP USA which requires all stock-based payments to employees, including grants of employee stock options, to be recognized in the consolidated financial statements based on their grant-date fair values.

We use the Black-Scholes option pricing model to determine the fair value of stock options which requires us to estimate certain key assumptions. In accordance with the application of GAAP USA, we incurred employee stock-based compensation cost of $95,000 for the year ended December 31, 2012. At December 31, 2012, we had $224,000 of unrecognized compensation cost relating to stock options.

Income Taxes and Deferred Tax Assets. Income taxes are accounted for as prescribed in GAAP USA. Under the asset and liability method of GAAP USA, the Company recognizes the amount of income taxes currently payable. 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. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years these temporary differences are expected to be recovered or settled.

As of December 31, 2012, the Company had a net deferred tax asset of $1,382,000 representing the amount the Company may recover in future years from future taxable income. As of December 31, 2011, the amount of the net deferred tax asset was $957,000. Each quarter and year-end, management makes a judgment to determine the extent to which the deferred tax asset will be recovered from future taxable income. Management reduced the valuation allowance related to the deferred tax asset to zero in 2010.

Fair Value Measurements

In September 2006, the FASB issued GAAP USA which defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the quality of inputs used to measure fair value and enhances disclosure requirements for fair value measurements. GAAP USA clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. GAAP USA also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based upon the best information available. In February 2008, the FASB issued guidance now codified in GAAP USA which provides for delayed application of certain guidance related to non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

In February 2007, the FASB issued GAAP USA which permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. GAAP USA was effective for us on January 1, 2008. We did not elect the fair value option for any assets or liabilities that were not previously carried at fair value. Accordingly, the adoption of GAAP USA had no impact on our consolidated financial statements.

In October 2008, the FASB issued clarification to GAAP USA which clarifies the application of GAAP USA in a market that is not active, and addresses application issues such as the use of internal assumptions when relevant observable data does not exist, the use of observable market information when the market is not active, and the use of market quotes when assessing the relevance of observable and unobservable data. GAAP USA is effective for all periods presented. The adoption of GAAP USA did not have a significant impact on our consolidated financial statements.

Reclassifications and Adoption of New Accounting Pronouncements

As of January 1, 2009 we adopted a new generally accepted accounting principle related to noncontrolling interest in the consolidated financial statements that required retrospective application, in which all periods presented reflect the necessary changes.

Item No. 7A – Qualitative and Quantitative Disclosures Regarding Market Risk

Not applicable.

Item No. 8 – Financial Statements and Supplementary Data

Reference is made to the Consolidated Financial Statements contained in Part IV hereof.

Item No. 9 – Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item No. 9A – Controls and Procedures

Disclosure Controls and Procedures

As required by Rule 13a-15(b) under the Exchange Act, we conducted an evaluation, under the supervision and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2012, the end of the period covered by this report. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated, as appropriate, to allow for timely decisions regarding required disclosure as of December 31, 2012. There were no material changes in our internal control over financial reporting during the fourth quarter of 2012 that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of the management and the Board; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Company assets that could have a material effect on the financial statements.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control – Integrated Framework issued by the Committee Sponsoring Organizations of the

Treadway Commission. This evaluation included review of the documentation of controls, evaluation of the design effectiveness of controls, testing of the operation effectiveness of controls and a conclusion on this evaluation. Although there are inherent limitations in the effectiveness of any system of internal controls over financial reporting, based on our evaluation, management has concluded our internal controls over financial reporting were effective as of December 31, 2012.

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's 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.

Item 9B – Other Information

None

PART III

Item No. 10 – Directors and Executive Officers of the Registrant

Information called for by Item 9 of Part III is incorporated by reference to the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders which is expected to be filed with the Commission within 120 days after December 31, 2012.

Item No. 11 – Executive Compensation

Information called for by Item 10 of Part III is incorporated by reference to the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders which is expected to be filed with the Commission within 120 days after December 31, 2012.

Item No. 12 – Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information called for by Item 11 of Part III is incorporated by reference to the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders which is expected to be filed with the Commission within 120 days after December 31, 2012.

Item No. 13 – Certain Relationships and Related Transactions

Information called for by Item 12 of Part III is incorporated by reference to the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders which is expected to be filed with the Commission within 120 days after December 31, 2012.

Item No. 14 – Principal Accountant Fees and Services

Information called for by Item 13 of Part III is incorporated by reference to the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders which is expected to be filed with the Commission within 120 days after December 31, 2012.

PART IV

Item No. 15 – Exhibits and Financial Statement Schedules

1. The Consolidated Financial Statements filed as part of this report on Form 10-K are listed on the accompanying Index to Consolidated Financial Statements and Consolidated Financial Statement Schedules.

2. Financial schedules required to be filed by Item 8 of this form, and by Item 15(d) below:

Schedule II Valuation and qualifying accounts

All other financial schedules are not required under the related instructions or are inapplicable and therefore have been omitted.

3. Exhibits:

Exhibit Number	Document
3.1	Third Restated Certificate of Incorporation of CTI Industries Corporation (Incorporated by reference to Exhibit A contained in Registrant’s Schedule 14A Definitive Proxy Statement for solicitation of written consent of shareholders, as filed with the Commission on October 25, 1999)
3.2	By-Laws of CTI Industries Corporation (Incorporated by reference to Exhibit 3.2, contained in Registrant’s Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
4.1	Form of CTI Industries Corporation’s common stock certificate (Incorporated by reference to Exhibit 4.1, contained in Registrant’s Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
10.1	CTI Industries Corporation 2001 Stock Option Plan (Incorporated by reference to Appendix E contained in Registrant’s Schedule 14A Definitive Proxy Statement, as filed with the Commission on May 21, 2001)
10.2	CTI Industries Corporation 2002 Stock Option Plan (Incorporated by reference to Appendix A contained in Registrant’s Schedule 14A Definitive Proxy Statement, as filed with the Commission on May 15, 2002)

10.3	CTI Industries Corporation 2007 Stock Incentive Plan (Incorporated by reference to Appendix A contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on April 30, 2007)
10.4	CTI Industries Corporation 2009 Stock Incentive Plan (Incorporated by reference to Schedule A contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on April 30, 2009)
10.5	Employment Agreement dated June 30, 1997, between CTI Industries Corporation and Howard W. Schwan (Incorporated by reference to Exhibit 10.9, contained in Registrant's Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
10.6	License Agreement between Rapak, LLC and the Company dated April 28, 2006 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K dated May 3, 2006)
10.7	Supply and License Agreement among Registrant and S.C. Johnson & Son, Inc. dated February 1, 2008 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K/A dated March 19, 2008)
10.8	Amendment to the License Agreement between Rapak, LLC and the Company dated May 6, 2008 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K dated May 8, 2008)
10.9	Credit Agreement between Harris N.A. and CTI Industries Corporation dated April 29, 2010 (Incorporated by reference to Exhibit 10.2 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.10	Mortgage and Security Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.3 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.11	Security Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.4 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.12	Pledge Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.5 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.13	Trademark License Agreement between S.C. Johnson & Son, Inc. and CTI Industries Corporation dated December 14, 2011 (Incorporated by reference to Exhibit 10.14 contained in Registrant's Report on Form 10-K dated March 29, 2012)
10.14	Third Amendment to Loan Agreement between BMO Harris Bank, N.A. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 10-Q dated August 14, 2012).

10.15	Replacement Revolving Note between BMO Harris Bank, N.A. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.2 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.16	Note and Warrant Purchase Agreement between BMO Private Equity, Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.3 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.17	Warrant Agreement between BMO Private Equity (U.S.), Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.4 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.18	Senior Secured Subordinated Promissory Note between BMO Private Equity (U.S.), Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.5 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.19	Employment Agreement between Howard W. Schwan and the Company dated September 24, 2012 (Incorporated by reference to Exhibit 10.6 contained in Registrant's Report on Form 10-Q dated November 14, 2012).
10.20	Consulting Agreement between Schwan Flexible Packaging, L.L.C, Howard W. Schwan, and the Company dated January 1, 2013 (Incorporated by reference to Exhibit 10.7 contained in Registrant's Report on Form 10-Q dated November 14, 2012).
10.21	Lease Agreement between Schultz Bros. Co. and the Company dated September 19, 2012 (Incorporated by reference to Exhibit 10.8 contained in Registrant's Report on Form 10-Q dated November 14, 2012).
14	Code of Ethics (Incorporated by reference to Exhibit contained in the Registrant's Form 10-K/A Amendment No. 2, as filed with the Commission on October 8, 2004)
21	Subsidiaries (description incorporated in Form 10-K under Item No. 1)
23.1	Consent of Independent Registered Public Accounting Firm, Plante & Moran, PLLC.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and rule 15d-14(a) of the Securities Exchange Act, as amended (filed herewith)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and rule 15d-14(a) of the Securities Exchange Act, as amended (filed herewith)
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

32

(a) The Exhibits listed in subparagraph (a)(3) of this Item 15 are attached hereto unless incorporated by reference to a previous filing.

(b) The Schedule listed in subparagraph (a)(2) of this Item 15 is attached hereto.

33

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act the Registrant caused this report to be signed on its behalf by the undersigned thereunto duly authorized on April 15, 2013.

CTI INDUSTRIES CORPORATION
By: /s/ Stephen M. Merrick
Stephen M. Merrick, President

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signatures	Title	Date
/s/ John H. Schwan John H. Schwan	Chief Executive Officer and Director	April 15, 2013
/s/ Stephen M. Merrick Stephen M. Merrick	President, Secretary, Chief Financial Officer and Director	April 15, 2013
/s/ Timothy S. Patterson Timothy S. Patterson	Controller, Senior Vice President of Finance and Administration, Chief Accounting Officer	April 15, 2013
/s/ Stanley M. Brown Stanley M. Brown	Director	April 15, 2013
/s/ Bret Tayne Bret Tayne	Director	April 15, 2013
/s/ John I. Collins John I. Collins	Director	April 15, 2013

/s/ Phil Roos Phil Roos	Director	April 15, 2013

34

EXHIBIT INDEX

Exhibit

Number Document

Exhibit Number	Document
3.1	Third Restated Certificate of Incorporation of CTI Industries Corporation (Incorporated by reference to Exhibit A contained in Registrant's Schedule 14A Definitive Proxy Statement for solicitation of written consent of shareholders, as filed with the Commission on October 25, 1999)
3.2	By-Laws of CTI Industries Corporation (Incorporated by reference to Exhibit 3.2, contained in Registrant's Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
4.1	Form of CTI Industries Corporation's common stock certificate (Incorporated by reference to Exhibit 4.1, contained in Registrant's Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
10.1	CTI Industries Corporation 2001 Stock Option Plan (Incorporated by reference to Appendix E contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on May 21, 2001)
10.2	CTI Industries Corporation 2002 Stock Option Plan (Incorporated by reference to Appendix A contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on May 15, 2002)
10.3	CTI Industries Corporation 2007 Stock Incentive Plan (Incorporated by reference to Appendix A contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on April 30, 2007)
10.4	CTI Industries Corporation 2009 Stock Incentive Plan (Incorporated by reference to Schedule A contained in Registrant's Schedule 14A Definitive Proxy Statement, as filed with the Commission on April 30, 2009)
10.5	Employment Agreement dated June 30, 1997, between CTI Industries Corporation and Howard W. Schwan (Incorporated by reference to Exhibit 10.9, contained in Registrant's Form SB-2 Registration Statement (File No. 333-31969) effective November 5, 1997)
10.6	License Agreement between Rapak, LLC and the Company dated April 28, 2006 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K dated May 3, 2006)

10.7	Supply and License Agreement among Registrant and S.C. Johnson & Son, Inc. dated February 1, 2008 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K/A dated March 19, 2008)
10.8	Amendment to the License Agreement between Rapak, LLC and the Company dated May 6, 2008 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 8-K dated May 8, 2008)
10.9	Credit Agreement between Harris N.A. and CTI Industries Corporation dated April 29, 2010 (Incorporated by reference to Exhibit 10.2 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.10	Mortgage and Security Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.3 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.11	Security Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.4 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.12	Pledge Agreement between Harris N.A. and the Company dated April 29, 2010 (Incorporated by reference to Exhibit 10.5 contained in Registrant's Report on Form 10-Q dated May 14, 2010)
10.13	Trademark License Agreement between S.C. Johnson & Son, Inc. and CTI Industries Corporation dated December 14, 2011 (Incorporated by reference to Exhibit 10.14 contained in Registrant's Report on Form 10-K dated March 29, 2012)
10.14	Third Amendment to Loan Agreement between BMO Harris Bank, N.A. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.1 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.15	Replacement Revolving Note between BMO Harris Bank, N.A. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.2 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.16	Note and Warrant Purchase Agreement between BMO Private Equity, Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.3 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.17	Warrant Agreement between BMO Private Equity (U.S.), Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.4 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.18	Senior Secured Subordinated Promissory Note between BMO Private Equity (U.S.), Inc. and the Company dated July 17, 2012 (Incorporated by reference to Exhibit 10.5 contained in Registrant's Report on Form 10-Q dated August 14, 2012).
10.19	Employment Agreement between Howard W. Schwan and the Company dated September 24, 2012 (Incorporated by reference to Exhibit 10.6 contained in Registrant's Report on Form 10-Q dated November 14, 2012).

10.20	Consulting Agreement between Schwan Flexible Packaging, L.L.C, Howard W. Schwan, and the Company dated January 1, 2013 (Incorporated by reference to Exhibit 10.7 contained in Registrant’s Report on Form 10-Q dated November 14, 2012).
10.21	Lease Agreement between Schultz Bros. Co. and the Company dated September 19, 2012 (Incorporated by reference to Exhibit 10.8 contained in Registrant’s Report on Form 10-Q dated November 14, 2012).
14	Code of Ethics (Incorporated by reference to Exhibit 14 contained in the Registrant’s Form 10-K/A Amendment No. 2, as filed with the Commission on October 8, 2004)
21	Subsidiaries (description incorporated in Form 10-K under Item No. 1)
23.1	Consent of Independent Registered Public Accounting Firm, Plante & Moran, PLLC.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and rule 15d-14(a) of the Securities Exchange Act, as amended (filed herewith)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and rule 15d-14(a) of the Securities Exchange Act, as amended (filed herewith)
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

37

CTI Industries Corporation

and Subsidiaries

Consolidated Financial Statements

Years ended December 31, 2012 and 2011

Contents

All other schedules for which a provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and, therefore, have been omitted.

Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of

CTI Industries Corporation and Subsidiaries

Lake Barrington, IL

We have audited the accompanying consolidated balance sheet of CTI Industries Corporation and Subsidiaries as of December 31, 2012, and the related consolidated statements of comprehensive income, stockholder's equity and cash flows for the year then ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit 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 consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and as evaluating the overall financial statement presentation. We believe that our audit provides 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 CTI Industries Corporation and Subsidiaries as of December 31, 2012, and the results of their operations and their cash flows for the year then ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related consolidated financial statement schedule for the year ended December 31, 2012, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Plante & Moran, PLLC

Chicago, Illinois

April 15, 2013

F-1

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

CTI Industries Corporation

We have audited the accompanying consolidated balance sheet of CTI Industries Corporation and Subsidiaries (the "Company") as of December 31, 2011, and the related consolidated statement of comprehensive income, stockholders' equity and cash flows for the year then ended. Our audit also included the financial statement schedule for the year ended December 31, 2011 listed in the Index at item 15(a). These consolidated financial statements and consolidated schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and consolidated schedule based on our audit.

We conducted our audit 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 consolidated financial statements are free of material misstatement. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 CTI Industries Corporation and Subsidiaries as of December 31, 2011, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Blackman Kallick, LLP

Chicago, Illinois

March 29, 2012

F-2

CTI Industries Corporation and Subsidiaries

Consolidated Balance Sheets

	December 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents (VIE $22,000 and $11,000, respectively)	$351,064	$338,523
Accounts receivable, (less allowance for doubtful accounts of $99,000 and $70,000 respectively)	7,773,332	7,091,194
Inventories, net	15,813,276	13,338,317
Net deferred income tax asset	846,371	760,241
Prepaid expenses (VIE $0 and $10,000 respectively)	1,525,092	1,345,223
Other current assets (VIE $108,000 and $83,000, respectively)	820,619	427,471
Total current assets	27,129,754	23,300,969
Property, plant and equipment:		
Machinery and equipment (VIE $701,000 and $550,000, respectively)	25,530,893	24,333,989
Building	3,360,017	3,329,174
Office furniture and equipment	3,137,123	3,022,719
Intellectual property	432,070	432,070
Land	250,000	250,000
Leasehold improvements	431,644	415,663
Fixtures and equipment at customer locations	2,784,419	2,629,902
Projects under construction	644,948	502,021
	36,571,114	34,915,538
Less : accumulated depreciation and amortization	(27,872,044)	(26,071,629)
Total property, plant and equipment, net	8,699,070	8,843,909
Other assets:		
Deferred financing costs, net	216,292	42,986
Goodwill	1,033,077	1,033,077
Net deferred income tax asset	535,954	197,243
Other assets (due from related party $19,000 and $79,000, respectively)	132,996	197,338
Total other assets	1,918,319	1,470,644
TOTAL ASSETS	$37,747,143	$33,615,522
LIABILITIES AND EQUITY		
Current liabilities:		
Checks written in excess of bank balance	$517,089	$154,501
Trade payables (VIE $66,000 and $0, respectively)	5,708,271	6,359,757

Line of credit	6,254,648	7,298,363
Notes payable - current portion (net discount of $107,000 and $0, repectively)		
(VIE $101,000 and $91,000, respectively)	354,342	362,927
Notes payable - officers, subordinated, current portion	1,123,742	1,424,923
Notes Payable Affiliates - current portion	8,113	6,718
Accrued liabilities (VIE $31,000 and $7,000, respectively)	2,997,242	2,081,805
Total current liabilities	16,963,447	17,688,994
Long-term liabilities:		
Notes Payable - Affiliates	141,052	134,919
Notes payable, net of current portion (net discount of $555,000 and $0, repectively)		
(VIE $533,000 and $687,000, respectively)	7,839,351	3,932,032
Notes payable - officers, subordinated	-	103,656
Capital Lease	-	426
Total long-term debt, net of current portion	7,980,403	4,171,033
Warrants Payable	721,247	-
Total long-term liabilities	8,701,650	4,171,033
Equity:		
CTI Industries Corporation stockholders' equity:		
Preferred Stock -- no par value 2,000,000 shares authorized		
0 shares issued and outstanding	-	-
Common stock - no par value, 5,000,000 shares authorized,		
3,320,773 and 3,276,633 shares issued and 3,248,646 and 3,137,348		
outstanding, respectively	13,775,994	13,704,890
Paid-in-capital	1,045,987	950,968
Accumulated deficit	(266,372)	(368,122)
Accumulated other comprehensive loss	(2,171,582)	(2,285,679)
Less: Treasury stock, 72,127 shares	(141,289)	(141,289)
Total CTI Industries Corporation stockholders' equity	12,242,738	11,860,768
Noncontrolling interest	(160,692)	(105,273)
Total Equity	12,082,046	11,755,495
TOTAL LIABILITIES AND EQUITY	$37,747,143	$33,615,522

See accompanying notes to consolidated financial statements

F-3

CTI Industries Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

	For the Year Ended December 31, 2012	2011
Net Sales	$49,542,762	$47,171,498
Cost of Sales	38,636,245	37,965,245
Gross profit	10,906,517	9,206,253
Operating expenses:		
General and administrative	6,357,249	5,278,507
Selling	1,720,878	910,882
Advertising and marketing	1,769,477	1,579,162
Total operating expenses	9,847,604	7,768,551
Income from operations	1,058,913	1,437,702
Other (expense) income:		
Interest expense	(1,013,295)	(794,152)
Interest income	22,143	21,041
Foreign currency gain	24,841	38,169
Total other expense, net	(966,311)	(734,942)
Income before taxes	92,602	702,760
Income tax expense	46,272	319,444
Net Income	46,330	383,316
Less: Net loss attributable to noncontrolling interest	(55,419)	(100,594)
Net income attributable to CTI Industries Corporation	$101,749	$483,910
Other Comprehensive Income		
Foreign currency adjustment	114,097	(692,881)
Comprehensive income (loss) attributable to CTI Industries Corporation	$215,846	$(208,971)
Basic income per common share	$0.03	$0.15

Diluted income per common share	$0.03	$0.15
Weighted average number of shares and equivalent shares of common stock outstanding:		
Basic	3,216,756	3,138,958
Diluted	3,293,106	3,181,102

See accompanying notes to consolidated financial statements

F-4

CTI Industries Corporation and Subsidiaries

Consolidated Statements of Stockholders' Equity

	CTI Industries Corporation									
	Common Stock Shares	Amount	Paid-in Capital	Value of warrants issued in connection with subordinated debt	Accumulated Deficit	Accumulated Other Comprehensive Loss	Less Treasury Stock Shares	Amount	Noncontrollin Interest	TO
Balance, December 31, 2010	3,209,475	$13,394,940	$817,138	$-	$(693,651)	$(1,592,798)	(72,127)	$(141,289)	$(4,679)	$1
Stock Purchase	63,158	$300,000								$3
Compensation relating to Option Issuance			$133,830							$1
Options Exercised	4,000	$9,950								$9
Dividends Declared					$(158,381)					$(
Net Income					$483,910				$(100,594)	$3
Other comprehensive income, net of taxes Foreign currency translation						$(692,881)				$(
Balance, December 31, 2011	3,276,633	$13,704,890	$950,968	$-	$(368,122)	$(2,285,679)	(72,127)	$(141,289)	$(105,273)	$1

Compensation relating to Option Issuance			$95,019							$9
Options Exercised	49,000	$95,304								$9
Stock exchanged for exercise of options	(4,860)	$(24,200)								$(
Net Income					$101,750				$(55,419)	$4
Other comprehensive income, net of taxes Foreign currency translation						$114,097				$1
Balance, December 31, 2012	3,320,773	13,775,994	1,045,987	-	(266,372)	(2,171,582)	(72,127)	(141,289)	(160,692)	$1

F-5

CTI Industries Corporation and Subsidiaries

Consolidated Statements of Cash Flows

	For the Year Ended December 31,	
	2012	2011
Cash flows from operating activities:		
Net income	$46,330	$383,316
Adjustment to reconcile net income to cash (used in) provided by operating activities:		
Depreciation and amortization	1,727,924	1,804,049
Amortization of debt discount	45,956	5,042
Change in value of swap agreement	(12,977)	158,090
Stock based compensation	95,019	133,830
Provision for losses on accounts receivable	29,681	20,714
Provision for losses on inventories	251,654	8,032
Deferred income taxes	(424,841)	153,830
Change in assets and liabilities:		
Accounts receivable	(536,373)	1,144,953
Inventories	(2,498,075)	(3,308,400)
Prepaid expenses and other assets	(455,557)	(753,267)
Trade payables	(1,002,822)	2,218,733
Accrued liabilities	633,715	(1,150,949)
Net cash (used in) provided by operating activities	(2,100,366)	817,973
Cash flows from investing activities - purchases of property, plant and equipment	(1,211,937)	(1,106,907)
Net cash used in investing activities	(1,211,937)	(1,106,907)
Cash flows from financing activities:		
Change in checks written in excess of bank balance	361,316	(535,524)
Net change in revolving line of credit	(1,055,015)	(208,251)
Repayment of long-term debt (related parties $413,000 and $268,000)	(854,405)	(506,272)
Proceeds from issuance of debt	5,005,531	970,523
Proceeds from exercise of stock options and warrants	67,232	9,950
Proceeds from issuance of stock, net	-	300,000
Dividends paid	-	(158,381)
Cash paid for deferred financing fees	(219,350)	(7,510)
Net cash provided by (used in) financing activities	3,305,309	(135,465)
Effect of exchange rate changes on cash	19,535	1,048

Net increase (decrease) in cash and cash equivalents	12,541	(423,351)
Cash and cash equivalents at beginning of year	338,523	761,874
Cash and cash equivalents at end of year	$351,064	$338,523
Supplemental disclosure of cash flow information:		
Cash payments for interest	$857,547	$767,965
Cash payments for taxes	$18,430	$42,250
Supplemental Disclosure of non-cash investing and financing activity		
Property, plant & equipment acquisitions funded by liabilities	$280,606	$49,248
Reclassification of line of credit to long-term debt	$-	$700,000
Exercise options and payments of subordinated debt	$3,872	$-

See accompanying notes to consolidated financial statements

F-6

Notes to Consolidated Financial Statements Years Ended

December 31, 2012 and 2011

1. Nature of Business

Nature of Operations

CTI Industries Corporation, its United Kingdom subsidiary (CTI Balloons Limited), its Mexican subsidiaries (Flexo Universal, S.A. de C.V., CTI Mexico Corporation, S.A. de C.V. and CTF International S.A. de C.V.), its German subsidiary (CTI Europe GmbH) and CTI Helium, Inc. (collectively, the "Company") (i) design, manufacture and distribute metalized and latex balloon products throughout the world and (ii) operate systems for the production, lamination, coating and printing of films used for food packaging and other commercial uses and for conversion of films to flexible packaging containers and other products.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of CTI Industries Corporation, its wholly owned subsidiaries CTI Balloons Limited, CTF International S.A. de C.V., and CTI Helium, Inc. and its majority owned subsidiaries, Flexo Universal, CTI Mexico Corporation and CTI Europe, as well as the accounts of Venture Leasing S. A. de R. L. and Venture Leasing L.L.C. The last two entities have been consolidated as variable interest entities. All significant intercompany accounts and transactions have been eliminated upon consolidation.

Variable Interest Entities

The determination of whether or not to consolidate a variable interest entity under U.S. GAAP requires a significant amount of judgment concerning the degree of control over an entity by its holders of variable interest. To make these judgments, management has conducted an analysis of the relationship of the holders of variable interest to each other, the design of the entity, the expected operations of the entity, which holder of variable interests is most "closely associated" to the entity and which holder of variable interests is the primary beneficiary required to consolidate the entity. Upon the occurrence of certain events, management reviews and reconsiders its previous conclusion regarding the status of an entity as a variable interest entity. Upon the adoption of amended accounting guidance applicable to variable interest entities on January 1, 2010, management continually reconsiders whether we are deemed to be a variable interest entity's primary beneficiary who consolidates such entity. The Company has two entities that have been consolidated as variable interest entities. (See Note 13)

Foreign Currency Translation

The financial statements of foreign subsidiaries are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities, the historical exchange rate for stockholders' equity, and a weighted average exchange rate for each period for revenues and expenses. Translation adjustments are recorded in accumulated other comprehensive income (loss) as the local currencies of the subsidiaries are the functional currencies. Foreign currency transaction gains and losses are recognized in the period incurred and are included in the consolidated statements of operations, except that, on November 30, 2012, the Company determined that it does have an expectation of receiving payment with respect to indebtedness of Flexo to the Company, and accordingly, as and after that date foreign currency gains and losses with respect to such indebtedness will be reported in the statement of operations.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the amounts reported of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period in the financial statements and accompanying notes. Actual results may differ from those estimates. The Company's significant estimates include valuation allowances for doubtful accounts, lower of cost or market of inventory, deferred tax assets, and recovery value of goodwill.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, demand deposits and short term investments with original maturities of three months or less.

Accounts Receivable

Trade receivables are carried at original invoice amount less an estimate for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by identifying troubled accounts, evaluating the individual customer receivables through consideration of the customer's financial condition, credit history and current economic conditions and use of historical experience applied to an aging of accounts. A trade receivable is considered to be past due if any portion of the receivable balance is outstanding for a period over the customer's normal terms. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received.

F-8

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using standard costs which approximates costing determined on a first-in, first-out basis, to reflect the actual cost of production of inventories.

Production costs of work in process and finished goods include material, labor and overhead. Work in process and finished goods are not recorded in excess of net realizable value.

Property, Plant and Equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to operations as incurred. Depreciation is computed using the straight-line method over estimated useful lives of the related assets. Leasehold improvements are amortized on a straight-line method over the lesser of the estimated useful life or the lease term. The estimated useful lives range as follows:

Building	25 - 30 years
Machinery and equipment	3 - 15 years
Projects that prolong the life and increase efficiency of machinery	3 - 5 years
Light Machinery	5 - 10 years
Heavy Machinery	10 - 15 years
Office furniture and equipment	5 - 8 years
Leasehold improvements	5 - 8 years
Furniture and equipment at customer locations	1 - 3 years

Light machinery consists of forklifts, scissor lifts, and other warehouse machinery. Heavy machinery consists of production equipment including laminating, printing and converting equipment. Projects in process represent those costs capitalized in connection with construction of new assets and/or improvements to existing assets including a factor for interest on funds committed to projects in process of $24,000 and $25,000 for the years ended December 31, 2012 and 2011, respectively. Upon completion, these costs are reclassified to the appropriate asset class.

Stock-Based Compensation

The Company has stock-based incentive plans which may grant stock option, restricted stock, and unrestricted stock awards. The Company recognizes stock-based compensation expense based on the grant date fair value of the award and the related vesting terms. The fair value of stock-based awards is determined using the Black-Scholes model, which incorporates assumptions regarding the risk-free interest rate, expected volatility, expected option life, and dividend yield. See Note 16 for additional information.

Fair Value Measurements

GAAP USA defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements required under other accounting pronouncements. See Note 4 for further discussion.

The Company accounts for derivative instruments in accordance with GAAP USA, which requires that all derivative instruments be recognized on the balance sheet at fair value. We enter into interest rate swaps to fix the interest rate on a portion of our variable interest rate debt to reduce the potential volatility in our interest expense that would otherwise result from changes in market interest rates. Our derivative instruments are recorded at fair value and are included in accrued liabilities of our consolidated balance sheet. Our accounting policies for these instruments are based on whether they meet our criteria for designation as hedging transactions, which include the instrument's effectiveness, risk reduction and, in most cases, a one-to-one matching of the derivative instrument to our underlying transaction. Gains and losses from changes in fair values of derivatives that are not designated as hedges for accounting purposes are recognized in the consolidated statement of operations. We have no derivative financial instruments designated as hedges. Therefore, changes in fair value for the respective periods were recognized in the consolidated statement of operations.

Goodwill

The Company applies the provisions of GAAP USA, under which goodwill is tested at least annually for impairment. Goodwill on the accompanying balance sheets relates to the Company's acquisition of Flexo Universal in a prior year as well as the investment in CTI Europe in a prior year. It is the Company's policy to perform impairment testing for Flexo Universal annually as of December 31, or as circumstances change. An annual impairment review was completed and no impairment was noted for the years ended December 31, 2012 and 2011 (see Note 14). While the Company believes that its estimates of future cash flows are reasonable, different assumptions regarding such cash flows could materially affect these evaluations.

Valuation of Long Lived Assets

The Company evaluates whether events or circumstances have occurred which indicate that the carrying amounts of long-lived assets (principally property, plant and equipment) may be impaired or not recoverable. The significant factors that are considered that could trigger an impairment review include: changes in business strategy, market conditions, or the manner of use of an asset; underperformance relative to historical or expected future operating results; and negative industry or economic trends. In evaluating an asset for possible impairment, management estimates that asset's future undiscounted cash flows and appraised values to measure whether the asset is recoverable. The Company measures the impairment based on the projected discounted cash flows of the asset over its remaining life.

Deferred Financing Costs

Deferred financing costs are amortized on a straight line basis over the term of the loan. Upon a refinancing, existing unamortized deferred financing costs are expensed.

Income Taxes

The Company accounts for income taxes using the liability method. As such, deferred income taxes reflect the net tax effects of temporary differences between carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Deferred tax assets and liabilities are measured using enacted tax rates expected to be in effect when the anticipated reversal of these differences is scheduled to occur. Deferred tax assets are reduced by a valuation allowance when, management cannot determine, in its opinion, that it is more likely than not that the Company will recover that recorded value of the deferred tax asset. The Company is subject to U.S. Federal, state and local taxes as well as foreign taxes in the United Kingdom, Germany and Mexico. U.S. income tax expense and foreign withholding taxes are provided on remittances of foreign earnings and on unremitted foreign earnings that are not indefinitely reinvested.

Unrecognized tax benefits are accounted for as required by GAAP USA which prescribes a more likely than not threshold for financial statement presentation and measurement of a tax position taken or expected to be taken in a tax return. See Note 10 for further discussion.

Revenue Recognition

The Company recognizes revenue when title transfers upon shipment. Revenue from a transaction is not recognized until (i) a definitive arrangement exists, (ii) delivery of the product has occurred or the services have been performed and legal title and risk are transferred to the customer, (iii) the price to the buyer has been fixed or is determinable, and (iv) collectability is reasonably assured. In some cases, product is provided on consignment to customers. For these cases, revenue is recognized when the customer reports a sale of the product.

Research and Development

The Company conducts product development and research activities which include (i) creative product development and (ii) engineering. During the years ended December 31, 2012 and 2011, research and development activities totaled $516,000 and $728,000, respectively.

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expenses amounted to $44,000 and $63,000 for the years ended December 31, 2012 and 2011, respectively.

3. New Accounting Pronouncements

In July 2012, the FASB issued new accounting guidance, which amends the existing guidance, related to impairment testing of indefinite-lived intangible assets. The amendments allow the option of performing a qualitative impairment assessment before calculating the fair value of the intangible assets, which could, depending on the results of the assessment, eliminate the need for further impairment testing. The guidance is effective for interim and annual periods beginning after September 15, 2012 with early adoption permitted. We do not expect the adoption of this guidance to have an impact on our consolidated financial position, results of operations or cash flows.

In February 2013, the FASB updated the guidance requiring companies to report, in one place, information about reclassifications of accumulated other comprehensive income (“AOCI”) and changes in AOCI balances. For significant items reclassified out of AOCI to net income in their entirety in the same reporting period, reporting is required about the effect of the reclassifications on the respective line items in the statement where net income is presented. For items that are not reclassified to net income in their entirety in the same reporting period, a cross reference to other disclosures currently required in conformity with accounting principles generally accepted in the United States is required. The above information must be presented in one place, either parenthetically on the face of the consolidated financial statements by income statement line item, or in a note. The adoption of this updated guidance is effective beginning with fiscal year 2013. The adoption of this guidance is not expected to have a material impact on our consolidated financial position, results of operations or cash flows, other than the related disclosures to the extent applicable.

In March 2013, the FASB issued ASU 2013-05, Foreign Currency Matters: Parent’s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity, or ASU 2013-05. ASU 2013-05 provides updated guidance to clarify the applicable guidance for a parent company’s accounting for the release of the cumulative translation adjustment into net income upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. This guidance is effective for fiscal periods beginning after December 15, 2013, and is to be applied prospectively to derecognition events occurring after the effective date. ASU 2013-05 is not expected to have a material impact on the Company's consolidated financial statements or financial statement disclosures.

4. Fair Value Disclosures; Derivative Instruments

GAAP USA clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. GAAP USA also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based upon the best information available.

GAAP USA establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy categorizes assets and liabilities at fair value into one of three different levels depending on the observability of the inputs employed in the measurement. The three levels are defined as follows:

- Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs are observable for the asset or liability, or unobservable but corroborated by market data, for substantially the full term of the financial instrument.
- Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of the input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability. The following table presents information about the Company's liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

Description	Amount as of 12/31/2012	Level 1	Level 2	Level 3
Interest Rate Swap 2011	$ 128,000	$ -	$ 128,000	$ -
Warrant Liability	721,000	-	721,000	-
	$ 849,000		$ 849,000	

Description	Amount as of 12/31/2011	Level 1	Level 2	Level 3
Interest Rate Swap 2011	$ 141,000	$ -	$ 141,000	$ -
	$ 141,000		$ 141,000	

The fair value of the detachable warrants was estimated on the date of the grant using the Black-Scholes option-pricing model. This model uses the assumptions listed in the table below as of July 17, 2012 (initial valuation date of the warrants). In the valuation of the warrants, it was determined that the warrants were required to be carried as a derivative liability at fair value. Changes in the fair value of the warrants have been recognized as of year-end.

The Company's interest rate swap agreements were valued using the counterparty's mark-to-market statement, which were validated using modeling techniques that include market inputs such as publically available interest rate yield curves, and were designated as Level 2 within the valuation hierarchy.

GAAP USA requires an entity to recognize all derivatives as either assets or liabilities in the consolidated balance sheet and to measure those instruments at fair value. Under certain conditions, a derivative may be specifically designated as a fair value hedge or a cash flow hedge.

As a result of the use of derivative instruments, the Company was exposed to risk that the counterparty might fail to meet their contractual obligations. Recent adverse developments in the global financial and credit markets could have negatively impacted the creditworthiness of our counterparty and caused them to fail to perform as expected. To mitigate the counterparty credit risk, we only entered into contracts with a major financial institution based upon their credit ratings and other factors, and continually assessed the creditworthiness of the counterparty. The counterparty performed in accordance with their contractual obligations.

On July 1, 2011, we entered into a swap agreement with BMO Capital Markets with respect to $6,780,000 of our loan balances with BMO Harris. This swap agreement limits the Company's exposure to interest rate fluctuations on the Company's floating rate loans. The swap agreement has the effect of fixing the interest rate on the loan balances covered by the swap at 4.65% per annum. The swap agreement is a derivative financial instrument and we determine and record the fair value of the swap agreement each quarter. This value is recorded on the balance sheet of the Company and the amount of the unrealized gain or loss for each period is recorded as interest income or expense on the statement of operations, as the swap is not designated as a hedge for accounting purposes.

Fair Values of Derivative Instruments in the Consolidated Balance Sheets

	Liability Derivatives			
As of December 31,	2012		2011	
Derivatives not designated as hedging instruments under Statement 133	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest Rate Contracts	Accrued Liabilities	$128,000	Accrued Liabilities	$141,000

The Effect of Derivative Instruments on the Consolidated Statements of Operations

December 31,	2012		2011	
Derivatives not Designated as Hedging Instruments under Statement 133	Location of Loss Recognized in Income on Derivative	Amount of Loss Recognized in Income on Derivative	Location of Loss Recognized in Income on Derivative	Amount of Loss Recognized in Income on Derivative
Interest Rate Contracts	Interest Expense	*$ (67,000)	Interest Expense	**$ (181,000)

*Includes interest of $80,000 associated with variances between fixed and variable rates.

**Designated as a cash flow hedge.

F-14

5. Other Comprehensive Loss

The following table sets forth the tax effects of components of other comprehensive loss and the accumulated balance of other comprehensive loss and each component.

Tax Effects Allocated to Each Component of Other Comprehensive Income (Loss)

for the years ended December 31, 2012 and 2011

	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2012			
Foreign currency translation adjustments	$114,097	$-	$114,097
Other comprehensive income	$114,097	$-	$114,097

	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2011			
Foreign currency translation adjustments	$(692,881)	$-	$(692,881)
Other comprehensive loss	$(692,881)	$-	$(692,881)

Accumulated Other Comprehensive Loss Balances as of December 31, 2012

	Foreign Currency Items	Unrealized Gain (Loss) on Derivatives	Accumulated Other Comprehensive Loss
Beginning balance	$(2,285,679)	$-	$(2,285,679)
Current period change	114,097	-	114,097
Ending balance	$(2,171,582)	$-	$(2,171,582)

Accumulated Other Comprehensive Loss Balances as of December 31, 2011

	Foreign Currency Items	Unrealized Gain (Loss) on Derivatives	Accumulated Other Comprehensive Loss

Beginning balance	$(1,592,798)	$-	$(1,592,798)
Current period change	(692,881)	-	(692,881)
Ending balance	$(2,285,679)	$-	$(2,285,679)

For the years ended December 31, 2012 and 2011, no tax benefit has been recorded on the foreign currency translation adjustments; as such amounts would result in a deferred tax asset and are not expected to reverse in the foreseeable future.

6. Major Customers

For the year ended December 31, 2012, the Company's top three customers accounted for approximately 26.3%, 8.9% and 7.5% of consolidated net sales. In 2011, the top three customers accounted for approximately 28.8%, 12.2% and 9.4%. At December 31, 2012, the outstanding accounts receivable balances due from these three customers were $2,021,000, $627,000 and $0, respectively. At December 31, 2011, the outstanding accounts receivable balances due from these three customers were $2,390,000, $746,000 and $0, respectively.

7. Inventories

Inventories are stated at the lower of cost or market. Cost is determined using standard costs which approximate costing determined on a first-in, first out basis. Standard costs are reviewed and adjusted periodically and at year end based on actual direct and indirect production costs. On a periodic basis, the Company reviews its inventory for estimated obsolescence or unmarketable items, primarily by reviewing future demand requirements and shelf life of the product.

Inventories are comprised of the following:

	December 31, 2012	December 31, 2011
Raw materials	$3,486,000	$3,027,000
Work in Process	1,388,000	1,503,000
Finished Goods	11,576,000	9,193,000
Allowance for excess quantities	(636,000)	(384,000)
Total inventories	$15,814,000	$13,339,000

F-16

8. Notes Payable and Capital Leases

Long term debt consists of:

	Dec. 31, 2012	Dec. 31, 2011
Mezzanine Note Payable BMO Private Equity, balance due January 18, 2018, interest at 11.50% (effective rate of 15.56%).	$5,000,000	$-
Less: Remaining debt discount to be amortized	(663,000)	-
Term Loan with Barrington Bank, payable in monthly installments of $11,000 amortized over 7 years, interest at 6.25%, balance due May 2016, which uses balloon production and related equipment as collateral.	633,000	779,000
Mortgage Loan with BMO Harris, payable in monthly installments of $7,778 plus interest at prime (3.25%) plus a premium rate (based on loan covenants) of 0.75% (4.00%) at December 31, 2012 and 2011, (amortized over 25 years), balance due July 18, 2017.	2,084,000	2,178,000
Equipment Loan with BMO Harris, payable in monthly installments of $22,323 beginning April 2012 plus interest at prime (3.25%) plus a premium rate (based on loan covenants) of 0.75% (4.00%) at December 31, 2012 and 2011, (amortized over 60 months), balance due March 31, 2017.	1,138,000	1,339,000
Capital Lease with Yale Financial Services, payable in monthly installments of $574 (amortized over 5 years).	-	3,000
Subordinated Notes (Officers) due on demand, interest at 9% (see Notes 9, 14).	29,000	33,000
Subordinated Notes (Officers) due on demand, interest at 8% (see Notes 9, 14).	595,000	795,000
Subordinated Notes (Officers) due on demand, interest at prime (3.25%) plus 2% (5.25%) at December 31, 2012 and 2011 (see Note 9).	500,000	597,000
Subordinated Notes (Officers) due 2013, interest at 8.5% (see Note 9).	-	104,000
Notes Payable (Affiliates) due 2015, interest at prime (3.25%) plus 0.25% (3.50%) at December 31, 2012 and 2011 (see Note 12).	30,000	28,000
Notes Payable (Affiliates) due 2021, interest at 11.75% (see Note 12).	116,000	112,000
Total long-term debt	9,462,000	5,968,000

Less current portion	(1,485,000)	(1,797,000)
Total Long-term debt, net of current portion	$7,977,000	$4,171,000

On April 29, 2010, the Company entered into a Credit Agreement and associated documents with BMO Harris under which BMO Harris agreed to extend to the Company a credit facility in the aggregate amount of $14,417,000. The facility includes (i) a Revolving Credit providing for maximum advances to the Company, and letters of credit, based upon the level of availability measured by levels of eligible receivables and inventory of the Company of $9,000,000, (ii) an Equipment Loan of up to $2,500,000 providing for loans for the purchase of equipment, (iii) a Mortgage Loan of $2,333,350, and (iv) a Term Loan in the amount of $583,333. The amount we can borrow on the Revolving Credit includes 85% of eligible accounts and 60% of eligible inventory (up to a maximum of $9,000,000). The Mortgage Loan is amortized over a term of 25 years. The maturity date of the facility is April 30, 2013. As of December 31, 2012 the balance outstanding on the Revolving Line of credit with BMO Harris was $6,109,000, which bears interest of 3.5%, leaving an available balance of $3,600,000. As of December 31, 2012, the balance on the outstanding Line of credit at Flexo Universal was $146,000, which bears interest of 13.6%.

Certain terms of the loan agreement, as amended, include:

- *Restrictive Covenants*: The Loan Agreement includes several restrictive covenants under which we are prohibited from, or restricted in our ability to:
  - Borrow money;
  - Pay dividends and make distributions;
  - Make certain investments;
  - Use assets as security in other transactions;
  - Create liens;
  - Enter into affiliate transactions;
  - Merge or consolidate; or
  - Transfer and sell assets.

- *Financial Covenants*: The Loan Agreement includes a series of financial covenants we are required to meet including:
  - We are required to maintain a tangible net worth (plus Subordinated Debt) in excess of $7,100,000 plus 50% of cumulative net income of the Company after January 1, 2010;
  - We are required to maintain specified ratios of senior debt to EBITDA on an annual basis and determined quarterly; and,
  - We are required to maintain a level of adjusted EBITDA to fixed charges on an annual basis determined quarterly of not less than 1.1 to 1. Adjusted EBITDA is EBITDA minus (i) taxes paid, (ii) dividends paid, (iii) payments for the purchase or redemption of stock, and (iv) unfunded capital expenditures.

As of December 31, 2012, the Company was not in compliance with two financial covenants provided in the Loan Agreement and one in the Note and Warrant Purchase Agreement. BMO Harris and BMO Equity have each executed waivers of such non-compliance by the Company (see Note 20).

On July 17, 2012, the Company entered into Amendment Number 3 to the Credit Agreement among the Company and BMO Harris pursuant to which (i) the amount of the loan commitment on the revolver loan of BMO Harris was increased from $9 million to $12 million, (ii) BMO Harris consented to a transaction among the Company and BMO Equity and (iii) the term of credit and loans to the Company provided in the Credit Agreement and BMO Harris was extended to July 17, 2017.

Also, on July 17, 2012, the Company entered into a Note and Warrant Purchase Agreement with BMO Equity pursuant to which (i) BMO Equity advanced to the Company the sum of $5 million and (ii) the Company issued to BMO Equity a detachable warrant to purchase up to Four Percent (4%) of the outstanding shares of common stock of the Company on a fully-diluted basis (140,048 shares of common stock of the Company) at the price of One Cent ($0.01) per share. A value of $703,000 was allocated to the detachable warrant. The term of the loan provided for in this Agreement is five and a half years. Interest is payable on the outstanding balance of the loan at the rate of 11.5% per annum.

The amortization of the debt discount will result in the Company's recognition of additional interest expense based on the effective interest method over the term of the underlying notes payable. Additional interest expense and accretion of $40,000 and $0 was recognized during 2012 and 2011, respectively.

The Note and Warrant Purchase Agreement includes provisions for:

(i) a closing fee of $100,000

(ii) payment of the principal amount in five and a half years with optional prepayment subject to certain prepayment premiums;

(iii) security for the note obligations in all assets of the Company junior to the security interest of BMO Harris;

(iv) various representations and warranties and covenants of the Company;

(v) financial covenants including an applicable senior leverage ratio, fixed charge coverage ratio and tangible net worth amount.

Future minimum principal payments for amounts outstanding under these long-term debt agreements for each of the years ended December 31 are:

2013	$1,485,000
2014	359,000
2015	380,000
2016	523,000
2017	1,689,000
Thereafter	5,026,000

Total	$9,462,000

9. Subordinated Debt

In February 2003, the Company received $1,630,000 from certain shareholders in exchange for (i) 9% subordinated notes and (ii) five year warrants to purchase 163,000 common shares at $4.87 per share. The proceeds were to (i) re-finance the bank loan of CTI Mexico in the amount of $880,000 and (ii) to provide financing for CTI Mexico and Flexo Universal. The value of the warrants was $460,000 calculated using Black-Scholes option pricing formula. The Company applied the discount against the subordinated debt. The discount was amortized using the effective interest method to interest expense over the term of the debt. These loans are subordinated to the bank debt of the Company. On February 8, 2008 those shareholders exercised these warrants in exchange for a reduction on these notes of $794,000. The remaining balance of $29,000 is due on demand.

In February 2006, the Company received $1,000,000 from certain shareholders in exchange for (i) five year subordinated notes bearing interest at 2% over the prime rate determined on a quarterly basis and (ii) five year warrants to purchase an aggregate of 303,030 shares of common stock of the Company at the price of $3.30 per share. The proceeds were to fund capital improvements and give additional liquidity to the Company. The value of the warrants was $443,000 using the Black-Scholes option pricing formula. The Company applied the discount against the subordinated debt. The discount was amortized using the effective interest method to interest expense over the term of the debt. These loans are subordinated to the bank debt of the Company. On May 28, 2010, these shareholders exercised all of these warrants in exchange for note indebtedness. The remaining balance of $500,000 is due on demand.

At various times from 2003 to 2005, certain shareholders loaned an aggregate of $814,000 to the Company in exchange for notes bearing interest at an annual rate of 8%. These notes are subordinated to the bank loan of the Company. The remaining balance of $595,000 is due on demand.

At various times from 2003 to 2006, certain shareholders loaned amounts to the Company in exchange for notes bearing interest of 8.5%. These notes are subordinated to the bank loan of the Company. The remaining balance has been paid as of December 31, 2012.

10. Income Taxes

The income tax provisions are comprised of the following:

	Dec. 31 2012	Dec. 31 2011
Current:		
Federal	$-	$-
State	-	15,851
Foreign	471,112	149,763
	$471,112	$165,614
Deferred		
Federal	$(112,978)	$228,524
State	-	-
Foreign	(311,862)	(74,694)
	(424,840)	153,830
Total Income Tax Provision	$46,272	$319,444

The components of the net deferred tax asset at December 31 are as follows:

	2012	2011
Deferred tax assets:		
Allowance for doubtful accounts	$20,534	$11,682
Inventory allowances	255,285	181,170
Accrued liabilities	73,929	70,765
Unicap 263A adjustment	151,625	151,625
Net operating loss carryforwards	602,580	955,717
Alternative minimum tax credit carryforwards	348,867	351,619
State investment tax credit carryforward	34,523	30,512
Foreign tax credit carryforward	615,080	298,635
Other foreign tax items	600,844	246,473
Total deferred tax assets	2,703,267	2,298,198
Deferred tax liabilities:		
Tax over book basis of capital assets	(1,113,335)	(1,175,615)
Other foreign tax items	(207,607)	(165,099)
Net deferred tax assets	$1,382,325	$957,484

The Company has a net operating loss carryforwards of approximately $1,502,000 expiring in various years through 2025. In addition, the Company has approximately $349,000 of alternative minimum tax credits as of December 31, 2012, which have no expiration date.

F-21

Income tax provisions differed from the taxes calculated at the statutory federal tax rate as follows:

	Years Ended December 31,	
	2012	2011
Taxes at statutory rate	$32,411	$245,966
State income taxes	5,718	43,395
Nondeductible expenses	57,937	57,772
Foreign taxes and other	(49,794)	(27,689)
Income tax provision	$46,272	$319,444

The Company files tax returns in the U.S., and in the U.K, Germany and Mexico foreign tax jurisdictions and also in various state jurisdictions in the U.S. The tax years 2009 through 2012 remain open to examination. Our policy is to recognize interest and penalties related to uncertain tax positions in income tax expense. During the twelve months ended December 31, 2012 and 2011, the Company did not recognize expense for interest or penalties, and do not have any amounts accrued at December 31, 2012 and 2011, as the Company does not believe it has taken any uncertain tax positions.

11. Employee Benefit Plan

The Company has a defined contribution plan for substantially all employees. Profit sharing contributions may be made at the discretion of the Board of Directors. Effective January 1, 2006, the Company amended its defined contribution plan. Under the amended plan, the maximum contribution for the Company is 4% of gross wages. Employer contributions to the plan totaled $126,000 and $113,000 for the years ended December 31, 2012 and 2011, respectively.

12. Related Party Transactions

Stephen M. Merrick, President and Chief Financial Officer of the Company, is of counsel to a law firm from which we received legal services during the year. Mr. Merrick is both a director and a shareholder of the Company. Legal fees paid to this firm were $143,000 and $127,000 for the years ended December 31, 2012 and 2011, respectively.

John H. Schwan, Chief Executive Officer of the Company, is a principal of Shamrock Packaging and affiliated companies. The Company made payments for of packaging materials, rent and temporary employees from Shamrock of approximately $2,985,000 and $2,019,000 during the years ended December 31, 2012 and 2011, respectively. At December 31, 2012 and 2011, outstanding accounts payable balances were $679,000 and $790,000, respectively.

During the period from January 2003 to the present, John H. Schwan, Chief Executive Officer of the Company, and Stephen M. Merrick, President and Chief Financial Officer, have made loans to the Company and to Flexo which have outstanding balances, for the Company of $1,124,000 and $1,425,000 and for Flexo of $0 and $104,000 as of December 31, 2012 and 2011, respectively.

During 2012 and 2011, interest expense to these individuals on these outstanding loans was $84,000 and $112,000, respectively (see Notes 10 and 12).

During 2010, two entities owned by John H. Schwan and Stephen M. Merrick provided financing for the acquisition and construction of latex balloon production and related equipment (see Note 13).

Other Assets include amounts due to the Company from its employees. As of December 31, 2012 and 2011, the balance outstanding on these amounts was $19,000 and $29,000, respectively.

Items identified as Notes Payable Affiliates in the Company's Consolidated Balance Sheet as of December 31, 2012 include loans by shareholders to Flexo Universal totaling $116,000 as well as a loan to CTI Europe totaling $30,000.

13. Variable Interest Entities (“VIE”) and Transactions

During 2010, two entities owned by officers and principal shareholders of the Company (John H. Schwan and Stephen M. Merrick) provided financing for Flexo Universal, the Company’s Mexico subsidiary, for the acquisition and construction of latex balloon production and related equipment. The entities included Venture Leasing L.L.C., (“VLUS”), an Illinois limited liability company which is 100% owned by an entity owned by Mr. Schwan and Mr. Merrick, and Venture Leasing Mexico S. A. de R. L (“VLM”), a Mexico company which is also owned 100% by entities owned by Mr. Schwan and Mr. Merrick. The Company is the primary beneficiary of VLUS & VLM and accordingly consolidated the result of the entities in its financial statements.

Mr. Schwan and Mr. Merrick, through entities owned by them, arranged for a line of credit in the amount of $1,000,000 from Barrington Bank in order to loan monies to VLUS as needed. During 2010, VLUS received advances on this line totaling $700,000. VLUS loaned substantially all of these funds to VLM. VLM utilized the funds to purchase materials, parts, components and services for the acquisition and construction of balloon production and related equipment to be placed at the premises of Flexo Universal. Assembly and construction of this equipment was completed on or about December 31, 2010 and, in January 2011, the equipment was placed in service at Flexo Universal.

Title to the equipment remains in the name of VLM. VLM leases the equipment to Flexo Universal under a three-year lease under which Flexo Universal will pay to VLM rental payments at the rate of approximately $9,000 per month and will have the right to purchase the equipment from VLM at the expiration of the lease at fair market value. The Company has not provided any guarantees related to VLUS or VLM and no creditors of the variable interest entities have recourse to the general credit of the Company as a result of including VLUS & VLM in the consolidated financial statements.

The accounts of VLM and VLUS have been consolidated with the accounts of the Company for 2012 and 2011 and will be consolidated in the future.

	Dec. 31, 2012	Dec. 31, 2011
Current Assets	$130,000	$105,000
Property, plant and equipment, net	662,000	550,000
Other noncurrent assets	622,000	774,000
Total assets	$1,414,000	$1,429,000
Mortgages and other long-term debt payable	$1,385,000	$1,488,000
Total liabilities	$1,385,000	$1,488,000

14. Goodwill

Under the provisions of GAAP USA, goodwill is subject to at least annual assessments for impairment by applying a fair-value based test. GAAP USA also requires that an acquired intangible asset should be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the asset can be sold, licensed, rented or exchanged, regardless of the acquirer's intent to do so. The Company has no acquired intangible assets other than goodwill.

As of December 31, 2012 and 2011, we determined that the fair value of the Company's interest in goodwill related to Flexo Universal as recorded was not impaired. The carrying amount of goodwill as of December 31, 2012 and 2011 was $989,000.

During 2010, the Company purchased an additional interest of $101,000 in its German subsidiary, CTI Europe, and recorded $44,000 of goodwill in the transaction. We have determined that the fair value of the Company's interest in the goodwill related to CTI Europe was not impaired as of December 31, 2012 and 2011.

15. Commitments

Operating Leases

The Company's United Kingdom subsidiary maintains a lease for office and warehouse space which expires December 2014 at a cost of $5,000 per month. In September 2010, the Company's German subsidiary entered into a 3-year lease to rent approximately 3,000 square feet of office and warehouse space in Heusenstamm, Germany at a cost of $2,000 per month. In August 2011, Flexo Universal entered into a 5-year lease to rent 73,000 square feet of warehouse and office space in Guadalajara, Mexico at the cost of $30,000 per month. In October 2011, we entered into a lease agreement, expiring on December 31, 2012, to rent approximately 30,000 square feet of warehouse space in Elgin, Illinois at a cost of $20,000 per month. In May 2012, we entered into a lease agreement, expiring on March 31, 2013 to rent approximately 23,000 square feet of warehouse space in Cary, Illinois at a cost of 10,000 per month. All of the Company's lease payments are recognized on a straight-line basis as none of the leases have escalation clauses. In September 2012, we entered into a lease agreement, expiring on February 28, 2017 to rent approximately 117,000 square feet of warehouse and office space in Lake Zurich, Illinois at a cost per month as follows:

Lease period	Amount per month
March 1, 2013 – October 31, 2013	$25,000
November 1, 2013 – October 31, 2014	28,000
November 1, 2014 – October 31, 2015	30,000
November 1, 2015 – October 31, 2016	33,000
November 1, 2016 – February 28, 2017	36,000

The net lease expense was $935,000 and $683,000 for the years ended December 31, 2012 and 2011, respectively.

The future aggregate minimum net lease payments under existing agreements as of December 31, are as follows:

2013	$949,000
2014	975,000
2015	907,000
2016	692,000
2017	72,000
Thereafter	-
Total	$3,595,000

Licenses

The Company has certain merchandising license agreements, which are of a one to two year duration that require royalty payments based upon the Company’s net sales of the respective products. The agreements call for guaranteed minimum commitments that are determined on a calendar year basis. Future guaranteed commitments due, as computed on a pro rata basis, as of December 31, are as follows:

2013	$271,000
2014	375,000
Thereafter	-
Total	$646,000

16. Stockholders' Equity

Stock Options

The Company has adopted GAAP USA which requires all stock-based payments to employees, including grants of employee stock options, to be recognized in the consolidated financial statements based on their grant-date fair values.

The Compensation Committee administers the stock-based plans. The exercise price for Incentive Stock Options ("ISO") cannot be less than the fair value of the stock subject to the option on the grant date (110% of such fair value in the case of ISOs granted to a stockholder who owns more than 10% of the Company's Common Stock). The exercise price of a Non-Qualified Stock Options ("NQSO") shall be fixed by the Compensation Committee at whatever price the Committee may determine in good faith. Unless the Committee determines otherwise, options beginning with the 2007 Plan generally have a 4-year term with a 3-year vesting schedule. Unless the Committee provides otherwise, options terminate upon the termination of a participant's employment, except that the participant may exercise an option to the extent it was exercisable on the date of termination and for a period of time after termination. Officers, directors and employees of, and consultants to the Company, or any parent or subsidiary corporation selected by the Committee, are eligible to receive options under the Plan. Subject to certain restrictions, the Committee is authorized to designate the number of shares to be covered by each award, the terms of the award, the date on which and the rates at which options or other awards may be exercised, the method of payment, vesting and other terms.

The Company has applied the Black-Scholes model to value stock-based awards. That model incorporates various assumptions in the valuation of stock-based awards relating to the risk-free rate of interest to be applied, the estimated dividend yield and expected volatility of the Company's Common Stock. The risk-free rate of interest is the U.S. Treasury yield curve for periods within the expected term of the option at the time of grant. The expected volatility is based on historical volatility of the Company's Common Stock.

The valuation assumptions we have applied to determine the value of stock-based awards were as follows:

Historical stock price volatility: The Company used the weekly closing price to calculate historical annual volatility.

Risk-free interest rate: The Company bases the risk-free interest rate on the rate payable on US treasury securities in effect at the time of the grant.

Expected life: The expected life of the option represents the period of time options are expected to be outstanding. The Company uses an expected life of 3.8 years.

Dividend yield: The estimate for dividend yield is 0.0%, as the Company did not issue dividends during 2012.

Estimated forfeitures: When estimating forfeitures, the Company considers historical terminations as well as anticipated retirements.

The Company, at the discretion of the board, may issue options in excess of the total available, if options related to that stock plan are cancelled. In some cases, not all shares that are available to a stock plan are issued, as the Company is unable to issue options to a previous plan when a new plan is in place.

The Company's pre-tax income for the fiscal year ended December 31, 2012 and 2011 includes approximately $95,000 and $134,000, respectively, of compensation costs related to share-based payments. As of December 31, 2012, there is $224,000 of unrecognized compensation expense related to non-vested stock option grants. We expect approximately $118,000, $70,000, $26,000, $8,000 and $2,000 to be recognized during 2013, 2014, 2015, 2016 and 2017 respectively.

On April 12, 2001, the Board of Directors approved for adoption, effective December 27, 2001, the 2001 Stock Option Plan ("2001 Plan"). The 2001 Plan authorizes the grant of options to purchase up to an aggregate of 119,050 shares of the Company's Common Stock. As of December 31, 2012, 139,958 options (including cancelled shares re-issued under the Plan) have been granted and were fully vested at the time of grant; 2,000 remain outstanding. During 2012, 5,500 options were exercised.

On April 24, 2002, the Board of Directors approved for adoption, effective October 12, 2002, the 2002 Stock Option Plan ("2002 Plan"). The 2002 Plan authorizes the grant of options to purchase up to an aggregate of 142,860 shares of the Company's Common Stock. As of December 31, 2012, 123,430 options have been granted and were fully vested at the time of grant; 27,500 remain outstanding. No options were exercised during 2012.

On June 22, 2007, the Board of Directors approved for adoption, effective October 1, 2007, the 2007 Stock Incentive Plan ("2007 Plan"). The 2007 Plan authorizes the grant of options to purchase up to an aggregate of 150,000 shares of the Company's Common Stock**.** On October 1, 2007, the company issued 74,000 options under the 2007 Plan. During 2008, the company issued an additional 77,500 options under the 2007 Plan. As of December 31, 2012, no options remain outstanding. During 2012, 43,500 options were exercised and 2,500 options expired.

Also under the 2007 Plan, in January 2010, the Company granted 14,250 restricted shares. During 2010, 7,125 shares had their restriction expire and the remaining 7,125 shares will have their restriction expire during 2011, the value of these shares were determined using the market value of the Company’s shares on the day the shares were issued.

F-27

On April 10, 2009, the Board of Directors approved for adoption, and on June 5, 2009, the shareholders of the Company approved the 2009 Stock Incentive Plan ("2009 Plan"). The 2009 Plan authorizes the issuance of up to 250,000 shares of stock or options to purchase stock of the Company. As of December 31, 2012, 191,000 options have been granted; 189,000 remain outstanding of which 17,500 are vested and 171,500 are not vested. During 2012, 1,500 options were cancelled and 109,000 options were granted. Of the total outstanding options, 21,000 have vesting schedule A, 29,000 have vesting schedule B, 30,000 have vesting schedule C, and 109,000 have vesting schedule D. Vesting schedules for the 2009 Plan are as follows:

Vesting Schedule A		Vesting Schedule B		Vesting Schedule C		Vesting Schedule D	
25 %	12 months	33 %	24 months	50 %	48 months	20 %	6 months
50 %	24 months	67 %	36 months	100%	57 months	40 %	18 months
75 %	36 months	100%	48 months			60 %	30 months
100%	48 months					80 %	42 months
						100%	54 months

The following is a summary of options exercised during the years ended December 31:

	2012		2011	
	Shares	Intrinsic Value	Shares	Intrinsic Value
2001 Plan Options	5,500	$11,150	-	$ -
2002 Plan Options	-	$-	-	$ -
2007 Plan Options	43,500	$135,016	-	$ -
2009 Plan Options	-	$-	4,000	$ 9,750

The following is a summary of the activity in the Company's stock option plans and other options for the years ended December 31, 2012 and 2011, respectively:

December 31, 2012		December 31, 2011	
Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price

Exercisable, beginning of period	86,625	$ 2.61	110,625	$ 3.36
Vested	12,250	5.97	22,250	2.97
Exercised	(49,000)	1.94	(4,000)	2.49
Cancelled	(2,875)	5.10	(42,250)	4.78
Exercisable at the end of period	47,000	$ 4.03	86,625	$ 2.61

F-28

	December 31, 2012		December 31, 2011	
	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
Outstanding, beginning of period	162,500	$ 4.25	202,750	$ 4.28
Granted	109,000	5.17	8,000	5.96
Exercised	(49,000)	1.94	(4,000)	2.49
Cancelled	(4,000)	5.35	(44,250)	4.84
Outstanding at the end of period	218,500	$ 5.21	162,500	$ 4.25

At December 31, 2012, available options to grant were 59,000 under the 2009 Plan.

Significant option groups remained outstanding at December 31, 2012 and related weighted average grant date fair value, remaining life and intrinsic value information are as follows:

	Options Outstanding				Options Vested			
Options by Grant Date	Shares	Weighted Avg.	Remain. Life	Intrinsic Val	Shares	Weighted Avg.	Remain. Life	Intrinsic Val
Dec 2005	29,500	$ 2.88	3.0	$67,260	29,500	$ 2.88	3.0	$67,260
Dec 2010	72,000	6.14	3.0	-	17,500	5.97	3.0	-
Jan 2011	8,000	5.96	3.0	-	-	-	-	-
Nov 2012	109,000	5.17	4.9	-	-	-	-	-
TOTAL	218,500	$ 5.21	4.0	$67,260	47,000	$ 4.03	3.0	$67,260

Warrants

In February 2006, certain members of company management were issued warrants, which fully vested immediately, to purchase 303,030 shares of the Company’s Common Stock at an exercise price of $3.30 per share in consideration of their loaning the company $1,000,000. The fair value of the warrants granted on February 1, 2006, was $443,000 which was estimated at the date of grant using the Black-Scholes pricing model. On May 28, 2010, all of these warrants were exercised in exchange for note indebtedness.

On October 1, 2008, the Company issued warrants to purchase 20,000 shares of common stock of the Company to both John Schwan and Stephen M. Merrick exercisable at the price of $4.80 per share (the market price of the stock on the date of the warrants) in consideration for the personal guarantees by each of up to $2 million in principal amount of the bank debt of the Company. On May 28, 2010, Mssrs. Schwan and Merrick exercised these warrants in exchange for outstanding indebtedness of the Company to them.

On July 17, 2012, the Company issued detachable warrants in connection with the Note and Warrant Purchase Agreement with BMO Equity (see Note 8). The warrants are exercisable at any time after July 17, 2012 and until July 17, 2022, or 18 months after full payment of the related $5,000,000 note payable, whichever is earlier, for up to 4% of the outstanding units of the Company (on a fully diluted basis) on the date of exercise. The warrants are exercisable at the purchase price of $0.01 per unit. At inception, the fair value allocated to the warrants of $703,000 was separately reflected as a noncurrent liability in the consolidated balance sheet.

The fair value of the detachable warrants was estimated on the date of the grant using the Black-Scholes option-pricing model. This model uses the assumptions listed in the table below as of July 17, 2012 (initial valuation date of the warrants). In the valuation of the warrants, it was determined that the warrants were required to be carried as a derivative liability at fair value. Changes in the fair value of the warrants have been recognized as of year-end.

	July 17, 2012	**December 31, 2012**
Weighted average fair value per warrant	$5.03	$4.87
Risk-free interest rate	0.99%	1.18%
Expected lives	7.50 years	7.00 years
Expected volatility	36.98%	28.18%

The following is a summary of the activity of the Company’s warrants for the years ended December 2012 and 2011:

	December 31, 2012		December 31, 2011	
	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
Outstanding and exercisable, beginning of period	-	$ -	-	$ -
Granted	140,048	0.01	-	-
Exercised	-	-	-	-
Cancelled	-	-	-	-
Outstanding and exercisable at the end of period	140,048	$ 0.01	-	$ -

The warrants outstanding and exercisable as of December 31, 2012 have a remaining life of 9.5 years and an intrinsic value of $721,000.

17. Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during each period.

Diluted earnings per share is computed by dividing the net income by the weighted average number of shares of common stock and equivalents (stock options and warrants), unless anti-dilutive, during each period.

For the three and twelve months ended December 31, 2012, 117,913 shares were anti-dilutive (not included in the determination of earnings on a diluted basis), all of which were represented by options. For the three months ended December 31, 2011, 84,000 shares were anti-dilutive shares. For the twelve months ended December 31, 2011, 81,500 shares were anti-dilutive, all of which were represented by options.

Consolidated Earnings per Share

	Year Ended December 31,	
	2012	2011
Basic		
Average shares outstanding:		
Weighted average number of shares outstanding during the period	3,216,756	3,138,958
Earnings:		
Net income attributable to CTI Industries Corporation	$101,749	$483,910
Amount for per share Computation	$101,749	$483,910
Net earnings applicable to Common Shares	$0.03	$0.15
Diluted		
Average shares outstanding:	3,216,756	3,138,958
Weighted averages shares Outstanding Common stock equivalents (options, warrants)	76,350	42,144
Weighted average number of shares outstanding during the period	3,293,106	3,181,102
Earnings:		
Net income attributable to CTI Industries Corporation	$101,749	$483,910
Amount for per share computation	$101,749	$483,910
Net income applicable to Common Shares	$0.03	$0.15

18. Geographic Segment Data

The Company's operations consist of a business segment which designs, manufactures, and distributes film products. Transfers between geographic areas were primarily at cost plus a standard markup. The Company's subsidiaries have assets consisting primarily of trade accounts receivable, inventory and machinery and equipment. Sales and selected financial information by geographic area for the years ended December 31, 2012 and 2011, respectively, are:

	United States	United Kingdom (UK)	Europe (Excluding UK)	Mexico	Consolidated
Year ended 12/31/12					
Sales to outside customers	$35,527,000	$2,427,000	$817,000	$10,772,000	$49,543,000
Total Assets	$27,708,000	$1,133,000	$1,057,000	$7,849,000	$37,747,000
	United States	**United Kingdom (UK)**	**Europe (Excluding UK)**	**Mexico**	**Consolidated**
Year ended 12/31/11					
Sales to outside customers	$34,657,000	$1,838,000	$376,000	$10,300,000	$47,171,000
Total Assets	$25,302,000	$734,000	$464,000	$7,116,000	$33,616,000

19. Contingencies

In the ordinary conduct of our business, we are from time to time subject to lawsuits, investigations and claims, including environmental claims and employee-related matters. Although we cannot predict with certainty the ultimate resolution of lawsuits, investigations and claims asserted against us, including civil penalties or other enforcement actions, we do not believe that any currently pending legal proceeding or proceedings to which we are a party will have a material adverse effect on our business, financial condition or results of operations.

20. Subsequent Event

On April 12, 2013, the Company entered into Amendment No. 4 to the Credit Agreement among the Company and BMO Harris Bank N.A. (the "Bank") (the "Credit Agreement Amendment") and also entered into Amendment No. 1 to the Note and Warrant Purchase Agreement among the Company and BMO Private Equity (U.S.) (the "NWPA Agreement Amendment").

In the Credit Agreement Amendment, the Bank, and in the NWPA Agreement Amendment, the Fund, waives defaults by the Company as of December 31, 2012 and March 31, 2013 with respect to certain financial covenants in the agreement relating to the Senior Leverage Ratio and Total Leverage Ratio. In addition, the levels of these financial covenants for June 30, 2013 and subsequent quarters during the term of the agreements are revised. Management believes that the Company will comply with these financial covenants, as revised, for the next 12 months.

Schedule II – Valuation and Qualifying Accounts:

The following is a summary of the allowance for doubtful accounts related to accounts receivable for the years ended December 31:

	2012	2011
Balance at beginning of year	$67,000	$59,000
Charged to expenses	30,000	21,000
Uncollectible accounts written off	(2,000)	(10,000)
Balance at end of year	$99,000	$70,000

The following is a summary of the allowance for excess inventory for the years ended December 31:

	2012	2011
Balance at beginning of year	$384,000	$376,000
Charged to expenses	252,000	8,000
Obsolete inventory written off	-	-
Balance at end of year	$636,000	$384,000

The following is a summary of property and equipment and the related accounts of accumulated depreciation for the years ended December 31:

	2012	2011
Cost Basis		
Balance at beginning of year	$34,342,000	$33,539,000
Additions	2,229,000	1,377,000
Disposals	-	-
Balance at end of year	$36,571,000	$34,916,000
Accumulated depreciation		
Balance at beginning of year	$26,072,000	$24,486,000
Depreciation	1,800,000	1,586,000
Disposals	-	-
Balance at end of year	$27,872,000	$26,072,000

F-33