SPAR GROUP INC
Form 10-Q
November 07, 2011

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

Form 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the third quarterly period ended September 30, 2011.

OR

o 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: 0-27824

SPAR Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware	33-0684451
State of Incorporation	IRS Employer Identification No.

560 White Plains Road, Suite 210, Tarrytown, New York 10591
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (914) 332-4100

Indicate by check 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:

x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

x Yes o No

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

Large Accelerated Filer o Accelerated Filer o

Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company x

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

On September 30, 2011, there were 20,099,287 shares of Common Stock outstanding.

SPAR Group, Inc.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SPAR Group, Inc.

Consolidated Balance Sheets
(In thousands, except share and per share data)

	September 30, 2011 (unaudited)	December 31, 2010 (note)
Assets		
Current assets:		
Cash and cash equivalents	$1,638	$923
Accounts receivable, net	12,696	13,999
Prepaid expenses and other current assets	772	1,283
Total current assets	15,106	16,205
Property and equipment, net	1,527	1,452
Goodwill	848	848
Intangibles	990	362
Other assets	419	226
Total assets	$18,890	$19,093
Liabilities and equity		
Current liabilities:		
Accounts payable	$1,541	$1,804
Accrued expenses and other current liabilities	2,498	2,733
Accrued expenses due to affiliates	1,237	1,575
Customer deposits	157	471
Lines of credit and other debt	4,155	5,263
Total current liabilities	9,588	11,846
Other long-term liabilities	391	–
Total liabilities	9,979	11,846
Equity:		
SPAR Group, Inc. equity		
Preferred stock, $.01 par value: Authorized and available shares – 2,445,598 Issued and outstanding shares – none – September 30, 2011, and 554,402 – December 31, 2010	–	6
Common stock, $.01 par value: Authorized shares – 47,000,000 Issued and outstanding shares – 20,099,287 – September 30, 2011, and 19,314,306 – December 31, 2010	201	193
Treasury stock	–	(1)
Additional paid-in capital	13,777	13,549
Accumulated other comprehensive loss	(280)	(142)
Accumulated deficit	(5,830)	(6,808)
Total SPAR Group, Inc. equity	7,868	6,797
Non-controlling interest	1,043	450

Total liabilities and equity	$18,890	$19,093

Note: The Balance Sheet at December 31, 2010, is excerpted from the consolidated audited financial statements as of that date but does not include certain information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes.

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SPAR Group, Inc.
Consolidated Statements of Income
(unaudited)
(In thousands, except per share data)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Net revenues	$17,564	$15,674	$49,925	$44,415
Cost of revenues	12,515	10,730	34,684	29,990
Gross profit	5,049	4,944	15,241	14,425
Selling, general and administrative expenses	4,368	4,350	13,078	12,520
Depreciation and amortization	280	229	808	725
Operating income	401	365	1,355	1,180
Interest expense, net	55	36	160	138
Other (income) expense	(30)	(77)	(22)	15
Income before provision for income taxes	376	406	1,217	1,027
Provision for income taxes	17	40	72	74
Net income	359	366	1,145	953
Net (income) loss attributable to the non-controlling interest	(112)	(41)	(137)	20
Net income attributable to SPAR Group, Inc.	$247	$325	$1,008	$973
Basic/diluted net income per common share:				
Net income – basic/diluted	$0.01	$0.02	$0.05	$0.05
Weighted average common shares – basic	20,081	19,203	19,911	19,161
Weighted average common shares- diluted	21,536	20,705	21,423	20,392

See accompanying notes.

SPAR Group, Inc. and Subsidiaries
Consolidated Statement of Equity
(unaudited)
(In thousands)

	Preferred Stock		Common Stock					Accumulated Other Comprehensive	Non-	
	Shares	Amount	Shares	Amount	Treasury Stock	Paid-In Capital	Accumulated Deficit	(Loss) Gain	Controlling Interest	Total Equity
Balance at December 31, 2010	554	$ 6	19,314	$ 193	$ (1)	$ 13,549	$ (6,808)	$ (142)	$ 450	$ 7,247
Preferred stock and accrued dividends converted to common stock	(554)	(6)	609	6	–	–	–	–	–	
Exercise of warrants			75	1	–	63	–	–	–	64
Issuance of stock options to employees & non-employees for services			–	–	–	258	–	–	–	258
Exercise of Options			101	1	–	35	–	–	–	36
Sale of non-controlling interest of subsidiary in India						(127)			217	90
Establishment of new subsidiaries with non-controlling interest									117	117
Distribution of subsidiary's equity							(30)		122	92
Reissued treasury stock					1	(1)				–
Comprehensive income:										
Foreign currency translation gain			–	–	–	–	–	(138)	–	(138)
Net Income							1,008	–	137	1,145
							1,008	(138)	137	1,007

Comprehensive income										
Balance at September 30, 2011	-	$ -	20,099	$ 201	$ -	$ 13,777	$ (5,830)	$ (280)	$ 1,043	$ 8,911

See accompanying notes.

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SPAR Group, Inc.

Consolidated Statements of Cash Flows
(unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2011	2010
Operating activities		
Net income	$1,145	$953
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation & Amortization	808	725
Issuance of stock options and warrants	258	154
Changes in non-controlling interest	124	119
Changes in operating assets and liabilities:		
Accounts receivable	1,253	(2,750)
Prepaid expenses and other assets	318	1,647
Accounts Payable	(263)	(1,503)
Accrued expenses, other current liabilities and customer deposits	(1,256)	425
Net cash provided by (used in) operating activities	2,387	(230)
Investing activities		
Purchases of property and equipment and capitalized software	(444)	(1,202)
Purchase of Mexican subsidiary	(400)	–
Net cash (used in) investing activities	(844)	(1,202)
Financing activities		
Net (payments) proceeds on lines of credit	(552)	176
Proceeds from options exercised	35	6
Proceeds from term debt	244	500
Payment on term debt	(500)	–
Payments on capital lease obligations	(75)	(101)
Net cash (used in) provided by financing activities	(848)	581
Effects of foreign exchange rate on cash	20	49
Net change in cash and cash equivalents	715	(802)
Cash and cash equivalents at beginning of period	923	1,659
Cash and cash equivalents at end of period	$1,638	$857
Supplemental disclosure of cash flows information		
Interest paid	$160	$207
Taxes paid	$198	$162
Supplemental disclosure of non-cash financing activities		
Liability related to acquisition of Mexican subsidiary	$300	$–
Preferred stock converted to common stock at par	$6	$–
Acquisition of equipment through capital lease	$140	$–

See accompanying notes.

SPAR Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
(unaudited)

1. Basis of Presentation

The accompanying unaudited, consolidated financial statements of SPAR Group, Inc., a Delaware corporation ("SGRP"), and its subsidiaries (together with SGRP, collectively, the "Company" or the "SPAR Group") have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included in these interim financial statements. However, these interim financial statements should be read in conjunction with the annual consolidated financial statements and notes thereto for the Company as contained in the Company's Annual Report for 2010 on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission (the "SEC") on March 15, 2011 (the "Company's Annual Report"). The Company's results of operations for the interim periods are not necessarily indicative of its operating results for the entire year.

2. Business and Organization

SPAR Group is a diversified international merchandising and marketing services company and provides a broad array of services worldwide to help companies improve their sales, operating efficiency and profits at retail locations. The Company provides its merchandising and other marketing services to manufacturers, distributors and retailers worldwide, primarily in mass merchandisers, office supply, grocery, drug store and other chains, and independent, convenience and electronics stores. The Company also provides furniture and other product assembly services in stores, homes and offices. The Company has supplied these project and product services in the United States since certain of its predecessors were formed in 1979 and internationally since the Company acquired its first international subsidiary in Japan in May of 2001. Today the Company currently operates in 9 countries that encompass approximately 46% of the total world population through operations in the United States, Canada, Japan, South Africa, India, Romania, China, Australia and Mexico.

Merchandising services primarily consist of regularly scheduled, special project and other product services provided at the store level, and the Company may be engaged by either the retailer or the manufacturer. Those services may include restocking and adding new products, removing spoiled or outdated products, resetting categories "on the shelf" in accordance with client or store schematics, confirming and replacing shelf tags, setting new sale or promotional product displays and advertising, replenishing kiosks, providing in-store event staffing, and providing assembly services in stores, homes and offices. Other merchandising services include whole store or departmental product sets or resets, including new store openings, new product launches and in-store demonstrations, special seasonal or promotional merchandising, focused product support and product recalls. The Company continues to seek to expand its merchandising, assembly and marketing services business throughout the world.

In order to cultivate foreign markets and expand the Company's merchandising and marketing services business outside of the United States, modify the necessary systems and implement its business model worldwide, and insure a consistent approach to its merchandising and marketing efforts worldwide, and even though it operates in a single business segment (merchandising and marketing services), the Company has divided its world focus into two geographic areas, the United States, which is the sales territory for its Domestic Merchandising Services Division, and international (i.e., all locations outside the United States), which are the sales territories for its International Merchandising Services Division. To that end, the Company also (1) provides and requires all of its locations to use

its Internet based operating, scheduling, tracking and reporting systems (including language translations, ongoing client and financial reports and ongoing IT support), (2) provides and requires all of its locations to comply with the Company's financial reporting and disclosure controls and procedures, (3) provides accounting and auditing support and tracks and reports certain financial and other information separately for those two divisions, and (4) has management teams in its corporate offices responsible for supporting and monitoring the management, sales, marketing and operations of each of the Company's international subsidiaries and maintaining consistency with the Company's other subsidiaries worldwide.

SPAR Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
(unaudited) (continued)

3. Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Numerator:				
Net income	$247	$325	$1,008	$973
Denominator:				
Shares used in basic net income per share calculation	20,081	19,203	19,911	19,161
Effect of diluted securities:				
Employee stock options	1,455	1,502	1,512	1,231
Shares used in diluted net income per share calculation	21,536	20,705	21,423	20,392
Basic and diluted net income per common share	$0.01	$0.02	$0.05	$0.05

4. Lines of Credit

Domestic Credit Facility ("Sterling Credit Facility"):

SGRP and certain of its domestic direct and indirect subsidiaries, namely SPAR Marketing Force, Inc., National Assembly Services, Inc., SPAR Group International, Inc., SPAR Trademarks, Inc., SPAR Incentive Marketing, Inc., PIA Merchandising Co., Inc., and SPAR Acquisition, Inc. (each a "Subsidiary Borrower", and together with SGRP, collectively, the " Borrowers "), entered into a Revolving Loan and Security Agreement dated as of July 6, 2010 (the "Loan Agreement"), with Sterling National Bank and Cornerstone Bank as the lenders (the "Lenders"), and issued their Secured Revolving Loan Notes in the original maximum principal amounts of $5.0 million to Sterling National Bank and $1.5 million to Cornerstone Bank (the "Notes"), to document and govern its new credit facility with them (the "Sterling Credit Facility"). In June 2011, the Lenders agreed to: (1) reduce the personal guarantee limits as noted below, and (2) extend the maturity of the Sterling Credit Facility until July 2013.

In addition, Mr. Robert G. Brown, a Director, the Chairman and a major stockholder of SGRP, and Mr. William H. Bartels, a Director, the Vice Chairman and a major stockholder of SGRP, have provided personal guarantees of the Sterling Credit Facility totaling $1,250,000 pursuant to their Limited Continuing Guaranty in favor of the Lenders dated as of July 6, 2010, as amended in June 2011 (the "Limited Guaranty").

Revolving Loans of up to $6.5 million are available to the Borrowers under the new Sterling Credit Facility based upon the borrowing base formula defined in the Loan Agreement (principally 85% of "eligible" domestic accounts receivable less certain reserves). The Sterling Credit Facility is secured by substantially all of the assets of the Borrowers (other than SGRP's foreign subsidiaries, certain designated domestic subsidiaries, and their respective

equity and assets).

The basic interest rate under the Sterling Credit Facility is equal to the fluctuating Prime Rate of interest published in the Wall Street Journal from time to time plus one and one-half (1.50%) percent per annum, which automatically changes with each change in such rate.

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SPAR Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(unaudited) (continued)

Due of the requirement to maintain a lock box arrangement with the Agent and the Lenders' ability to invoke a subjective acceleration clause at its discretion, borrowings under the Sterling Credit Facility will be classified as current.

The Sterling Credit Facility contains certain financial and other restrictive covenants and also limits certain expenditures by the Borrowers, including, but not limited to, capital expenditures and other investments. At September 30, 2011, the Company was in compliance with such covenants and does not expect to be in violation at future measurement dates. However, there can be no assurances that the Company will not be in violation of certain covenants in the future, and should the Company be in violation; there can be no assurances that the Lenders will issue waivers for any future violations.

International Credit Facilities:

In 2008, the Australian subsidiary, SPARFACTS Australia Pty. Ltd., entered into a revolving line of credit arrangement (as amended in September 2009) with Commonwealth Bank of Australia (CBA) for $1.5 million (Australian), or approximately $1.5 million (based upon the exchange rate at September 30, 2011).

On October 20, 2006, SPAR Canada Company, a wholly owned subsidiary, entered into a secured credit agreement with Royal Bank of Canada providing for a Demand Operating Loan for a maximum borrowing of $750,000 (Canadian) or approximately $726,000 (based upon the exchange rate at September 30, 2011). The Demand Operating Loan provides for borrowing based upon a formula as defined in the agreement (principally 75% of eligible accounts receivable less certain deductions) and a minimum total debt to tangible net worth covenant. The Company was in compliance with the minimum total debt to tangible net worth covenant under this line of credit at September 30, 2011.

On March 26, 2010 the Company signed a Loan and Security Agreement and a Promissory Note with Michael Anthony Holdings, Inc. for a total of $500,000 which was used for the acquisition of certain assets of a Canadian company that closed on April 1, 2010. The loan was payable on an interest only basis and matured on March 31, 2011 and was paid in full on that date.

On March 7, 2011, the Japanese subsidiary, SPAR FM Japan, Inc., a wholly owned subsidiary, secured a loan with Mizuho Bank in the amount of 20.0 million Japanese Yen, or approximately $261,000. The loan is payable in monthly installments of 238,000 Yen or $3,100 at an interest rate of 0.1% per annum with a maturity date of February 28, 2018. The outstanding balance at September 30, 2011, was approximately 18 million Yen or $239,000 (based upon the exchange rate at September 30, 2011).

Summary of Company Credit and Other Debt Facilities:

(in thousands)

	September 30, 2011	Average Interest Rate	December 31, 2010	Average Interest Rate
Credit Facility Loan Balance:				
USA, Sterling Credit Facility and predecessors	$3,782	4.75 %	$3,536	4.87 %

Australia	131	10.24	%	548	10.24	%
Canada	242	4.00	%	623	4.00	%
	$4,155			$4,707		

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SPAR Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(unaudited) (continued)

	September 30, 2011	December 31, 2010
Unused Availability:		
USA – Sterling Facility	$2,300	$1,700
Australia	1,369	952
Canada	149	87
	$3,818	$2,739
Other Debt:	$239	$556

5. Capital Lease Obligations

The Company has three outstanding capital lease obligations (in thousands):

Start Date:	Original Cost	Accumulated Depreciation	Net Book Value as of September 30, 2011
July 2010	$215	$84	$131
November 2010	48	15	33
June 2011	140	11	129
	$403	$110	$293

Annual future minimum lease payments required under the lease, together with the present value as of September 30, 2011, are as follows (in thousands):

Year Ending December 31,	Amount
2011	$ 38
2012	154
2013	110
2014	23
	325
Less amount representing interest	32
Present value of net minimum lease payments included with other liabilities	$ 293

6. Related-Party Transactions

SGRP's policy respecting approval of transactions with related persons, promoters and control persons is contained in the SPAR Group Code of Ethical Conduct for its Directors, Senior Executives and Employees Dated (as of) May 1, 2004 (the "Ethics Code"). Article V of the Ethics Code generally prohibits each "Covered Person" (including SGRP's officers and directors) from engaging in any business activity that conflicts with his or her duties to the Company, and directs each "Covered Person" to avoid any activity or interest that is inconsistent with the best interests of the SPAR

Group, in each case except for any "Approved Activity" (as such terms are defined in the Ethics Code). Examples of violations include (among other things) having any ownership interest in, acting as a director or officer of or otherwise personally benefiting from business with any customer or vendor of the Company other than pursuant to any Approved Activity. Approved Activities include (among other things) anything disclosed to and approved by the Board, the Governance Committee or the Audit Committee, as the case may be, as well as the ownership, board and executive positions held by certain executive officers in SMS and SMSI (as defined and described below). The Company's senior management is generally responsible for monitoring compliance with the Ethics Code and establishing and maintaining compliance systems, including conflicting relationships and transactions, subject to the review and oversight of SGRP's Governance Committee as provided in clause IV.11 of the Governance Charter, and its Audit Committee as provided in clause I.2(l) of the Audit Charter. The Governance Committee and Audit Committee each consist solely of independent outside directors.

SPAR Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(unaudited) (continued)

SGRP's Audit Committee periodically reviews and has approved all of the related party relationships and transactions described above, as required by and in accordance with its Charter and the Company's Code of Ethical Conduct, NASDAQ rules and applicable law, the Audit Committee reviews each material related party transaction for its overall fairness to the Company, both initially and periodically (often annually), which review includes (without limitation) the costs and benefits to the Company, the other terms of the transactions, the affiliated relationship of the parties, and whether the overall economic and other terms are (or continue to be) no less favorable to the Company than would be the case with an unrelated provider of substantially similar services.

Mr. Robert G. Brown, a Director, the Chairman and a major stockholder of SGRP, and Mr. William H. Bartels, a Director and the Vice Chairman of the Company and a major stockholder of SGRP, are executive officers and the sole stockholders and directors of SPAR Marketing Services, Inc. ("SMS"), SPAR Management Services, Inc. ("SMSI"), and SPAR InfoTech, Inc. ("SIT").

SMS and SMSI provided approximately 99% of the Company's domestic merchandising specialists field force for both the nine months ended September 30, 2011 and 2010, and approximately 92% and 91% of the Company's domestic field management at a total cost of approximately $16.1 million and $14.8 million for the nine months ended September 30, 2011 and 2010, respectively. Pursuant to the terms of the Amended and Restated Field Service Agreement dated as of January 1, 2004, as amended (the "Field Services Agreement"), SMS provides merchandising services to the Company through the use of approximately 6,600 of its field force of merchandising specialists. Pursuant to the terms of the Amended and Restated Field Management Agreement dated as of January 1, 2004, SMSI provides 54 full-time national, regional and district managers to the Company. For those services, the Company has agreed to reimburse SMS and SMSI for all of their costs of providing those services and to pay SMS and SMSI each a premium equal to 4% of their respective costs (the "Plus Compensation"). The total Plus Compensation earned by SMS and SMSI for services rendered was approximately $622,000 and $565,000 for the nine months ended September 30, 2011 and 2010, respectively.

The Company has continued to purchase those services because it believes the terms it receives from them are at least as favorable to the Company as it could obtain from non-affiliated providers of similar services. The Company periodically engages an outside firm to conduct a survey of fees and rates charged by comparable national labor sourcing firms to serve as a comparison to the rates charged by such affiliates. The most recent such survey showed that the rates negotiated with the Affiliates are in fact slightly less than those charged by unrelated vendors providing similar services. The Company's cost of revenue would have increased by $485,000 and $444,000 for the nine months ended September 30, 2011 and 2010, respectively, if the Company would have instead used an unaffiliated entity to provide comparable services at the surveyed rates. All affiliate contracts are reviewed and approved by SGRP's Audit Committee, as described below.

The Company has been advised that Messrs. Brown and Bartels are not paid any salaries as officers of SMS or SMSI so there were no salary reimbursements for them included in such costs or premium. However, since SMS and SMSI are "Subchapter S" corporations and are owned by Messrs. Brown and Bartels, all income from SMS and SMSI is allocated to them.

In July 2008, the Company, through SPAR Marketing Force, Inc. ("SMF"), entered into a new Master Lease Agreement with SMS, and in July and September of 2008 entered into new separate operating leases with SMS pursuant to Equipment Leasing Schedules under that Master Lease Agreement. Each operating lease had a 36 month term and representations, covenants and defaults customary for the leasing industry. The leases are for handheld computers to

be used by field merchandisers in the performance of various merchandising and marketing services in the United States and have a total monthly payment of $11,067. These handheld computers had an original purchase price of $401,188. The monthly payments were based upon a lease factor of 3.1%. As of September 2011, these lease agreements expired and were paid in full. In addition, SMS has granted SMF continued use of the equipment at no additional charge to insure continued compliance with the Field Services Agreement noted above. The Company estimates that the value of the handheld computers is approximately $2,000 to $4,000 per month.

SPAR Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
(unaudited) (continued)

The following transactions occurred between the Company and the above affiliates (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Services provided by affiliates:				
Merchandising services (SMS)	$4,234	$4,250	$12,941	$11,731
Field management services (SMSI)	$1,068	$1,020	$3,250	$3,075
Handheld computer leases (SMS)	$11	$33	$77	$99
Total services provided by affiliates	$5,313	$5,303	$16,268	$14,905

	September 30, 2011	December 31, 2010
Total accrued expenses due to affiliates	$1,237	$1,575

In July 1999, SMF, SMS and SIT entered into a software ownership agreement providing that each party independently owned an undivided share of and had the right to unilaterally license and exploit their "Business Manager" Internet job scheduling software (which had been jointly developed by such parties), and all related improvements, revisions, developments and documentation from time to time made or procured by any of them. In addition, SPAR Trademarks, Inc. ("STM"), SMS and SIT entered into separate trademark licensing agreements whereby STM has granted non-exclusive royalty-free licenses to SIT and SMS (and through them to their commonly controlled subsidiaries and affiliates by sublicenses, including SMSI through SMS) for their continued use of the name "SPAR" and certain other trademarks and related rights transferred to STM, a wholly owned subsidiary of SGRP.

Through arrangements with the Company, SMS and SMSI participate in various benefit plans, insurance policies and similar group purchases by the Company, for which the Company charges them their allocable shares of the costs of those group items and the actual costs of all items paid specifically for them. All transactions between the Company and the above affiliates are paid and/or collected by the Company in the normal course of business.

In addition to the above, through the services of Affinity Insurance, Ltd. (“Affinity”), the Company purchases insurance coverage for its casualty and property insurance risk. The Company’s Chairman and Vice Chairman own, through SMSI, a minority (less than 1%) equity interest in Affinity.

On December 31, 2010, there were 338,801 shares of SGRP's Series A Preferred Stock owned by a non-SGRP retirement plan whose trustee is and beneficiaries include Robert G. Brown (who is a co-founder, director, executive officer and significant shareholder of SGRP), and there were 215,601 shares of SGRP's Series A Preferred Stock owned by a non-SGRP retirement plan whose trustee is and beneficiaries include William H. Bartels (who also is a co-founder, director, executive officer and significant shareholder of SGRP), which shares collectively constituted all

of the outstanding shares of Series A Preferred Stock issued by SGRP. Those shares were originally purchased pursuant to subscription agreements on March 31, 2008, and September 24, 2008, at the closing Nasdaq bid price of SGRP's Common Stock for the preceding trading day, which was $1.12 per share for the March purchases and $0.86 per share for the September purchases. Each share of SGRP's Series A Preferred Stock could be converted into one share of SGRP's Common Stock (at the rate of one to one), at the option of the holder and without further consideration, and accumulated dividends at the rate of ten percent per annum. SGRP's Audit Committee and Board of Directors each reviewed and unanimously approved this transaction, including the pricing, conversion and other terms of the Preferred Stock and the affiliated relationship of the parties. The offer and sale of such Preferred Stock have not been registered under the Securities Act or other securities laws, as they were a non-public offer and sale made in reliance upon (among other things) Section 4 (2) of the Securities Act.

SPAR Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(unaudited) (continued)

On or before March 10, 2011, Mr. Brown and Mr. Bartels, as trustees of those plans, each had requested that their plan's preferred shares be converted into SGRP's Common Stock in accordance with its terms, and in order to facilitate conversion of those shares by payment of all accrued and unpaid dividends, on March 10, 2011, SGRP's Board of Directors (i) fixed March 10, 2011, as the applicable record date for determination of the holders of the SGRP's Series A Preferred Stock eligible to receive such dividends, (ii) declared a dividend on such SGRP's Series A Preferred Stock equal to the accrued and unpaid dividends thereon, payable in shares of SGRP's Common Stock valued at their market value ($2.34 per share) on such record date, and (iii) authorized the issuance of the shares of SGRP's Common Stock necessary to effect such conversion (554,402 shares) and accrued dividend payment (54,584 shares) in consideration of the preferred shares surrendered and the accrued dividends thereby satisfied. As a result of such conversions and stock dividends, on March 11, 2011, Mr. Brown's plans received 372,158 shares of SGRP's Common Stock (33,357 shares of which were for accrued dividends) and Mr. Bartel's plan received 236,828 shares of SGRP's Common Stock (21,227 shares of which were for accrued dividends).

In the event of any material dispute in the business relationships between the Company and SMS, SMSI, or SIT, it is possible that Messrs. Brown or Bartels may have one or more conflicts of interest with respect to these relationships and such dispute could have a material adverse effect on the Company.

7. Preferred Stock

SGRP's certificate of incorporation also authorized it to issue 3,000,000 shares of preferred stock with a par value of $0.01 per share (the "SGRP Preferred Stock"), which may have such preferences and priorities over the SGRP Common Stock and other rights, powers and privileges as the Company's Board of Directors may establish in its discretion from time to time. The Company has created and authorized the issuance of a maximum of 3,000,000 shares of Series A Preferred Stock pursuant to SGRP's Certificate of Designation of Series "A" Preferred Stock (the "SGRP Series A Preferred Stock"), which have dividend and liquidation preferences, have a cumulative dividend of 10% per year, are redeemable at the Company's option and are convertible at the holder's option (and without further consideration) on a one-to-one basis into SGRP Common Stock. After the Series A Preferred Stock conversion described in Note 6, above, 2,445,598 shares of SGRP Series A Preferred Stock remained authorized and available for issuance under SGRP's certificate of incorporation and Certificate of Designation of Series "A" Preferred Stock. The number of shares authorized by such designation could, however, be reduced by amendment or redemption to facilitate the creation of other SGRP Preferred Series.

8. Stock-Based Compensation

SGRP currently grants options to its eligible directors, officers and employees and certain employees of its affiliates to purchase shares of Common Stock issued by SGRP ("SGRP Shares") pursuant to its 2008 Stock Compensation Plan, (as amended, the "2008 Plan"). SGRP also has granted stock options that continue to be outstanding under various predecessor stock option plans (each a "Prior Plan"). The Prior Plans consist of the following: the Amended and Restated 1995 Stock Option Plan (the "1995 Plan"); and the 2000 Stock Option Plan ("2000 Plan"), which succeeded the 1995 Plan. Each Prior Plan will continue to be outstanding for the purposes of any remaining outstanding options issued under it for so long as such options are outstanding. As described below, SGRP has the authority to issue other types of stock-based awards under the 2008 Plan, but (except for the restricted stock award described below) to date it has not done so.

On May 29, 2008, SGRP's stockholders approved and adopted the 2008 Plan as the successor to the Prior Plans with respect to all new options issued. The 2008 Plan provides for the granting of either incentive or nonqualified stock options to purchase SGRP Shares, restricted SGRP Shares, and restricted stock units, stock appreciation rights and other awards based on SGRP Shares ("Awards") to SGRP Directors and the Company's specified executives, employees and consultants (which are employees of certain of its affiliates), although to date SGRP has not issued any permissible form of award other than stock options. Unless terminated sooner as provided therein, the 2008 Plan will terminate on May 28, 2018, which is ten years from the 2008 Plan Effective Date, and no further Awards may be made under it. However, any existing Awards made prior to such termination will continue in accordance with their respective terms and will continue to be governed by the 2008 Plan. Stock options granted under the 2008 Plan have a maximum term of ten years, except in the case of incentive stock options granted to greater than 10% stockholders (whose terms are limited to a maximum of five years), and SGRP has generally issued options having maximum terms.

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The 2008 Plan limits the number of SGRP Shares that may be covered by Awards ("Outstanding Covered Shares") to 5,600,000 SGRP Shares in the aggregate (the "Maximum Covered Shares"), which Outstanding Covered Shares for this purpose consist of the sum of (i) the SGRP Shares covered by all Awards issued under the 2008 Plan on or after May 29, 2008 ("New Awards"), plus (ii) and the SGRP Shares covered by all stock options issued at any time under the 2000 Plan or 1995 Plan to the extent they were still outstanding on May 29, 2008 ("Continuing Awards"). SGRP Shares covered by New Awards or Continuing Awards that expire, lapse, terminate, are forfeited, become void or otherwise cease to exist (other than as a result of exercise) are no longer Outstanding Covered Shares, are added back to remaining availability under the Maximum Covered Shares and thus become available for New Award grants, while those SGRP Shares covered by exercised New Awards or Continuing Awards continue to be Outstanding Covered Shares and are not added back to, and thus continue to reduce, the remaining availability under the Maximum Covered Shares under the 2008 Plan. The Outstanding Covered Shares and Maximum Covered Shares (as well as the SGRP Shares covered by a particular Award) are all subject to certain adjustments that may be made by the Compensation Committee upon the occurrence of certain changes in the Corporation's capitalization or structure as provided in the 2008 Plan. Except for the adjustments described above, an increase in the Maximum Covered Shares requires the consent of the SGRP stockholders under the terms of the 2008 Plan and Exchange Rules.

Stock options may be issued from time to time by SGRP in its discretion. At each of its regular quarterly meetings, the Compensation Committee receives, discusses and approves (as and to the extent modified by them) management's recommendations respecting the discretionary issuance of stock options to executives and employees of the Company pursuant to the 2008 Plan. The Chairman of the Board or the Compensation Committee may make those recommendations respecting Mr. Raymond, Mr. Raymond as Chief Executive Officer makes those recommendations respecting Mr. Segreto, Ms. Belzer and Ms. Franco, as well as for any new officer, and each of those executives in turn are allocated potential option shares for their departments and make recommendations respecting those under their supervision (subject to review and approval by Mr. Raymond). In recommending to the Compensation Committee the actual number of options (and options shares covered) to be granted to each individual, the person making the recommendation makes an assessment of the individual's contribution to the Company's overall performance, the individual's successful completion of a special project, and any significant increase or decrease in the participant's abilities, responsibilities and performance of his or her duties. The Compensation Committee reviews managements' recommendations at its meeting and determines whether and to what extent to approve the proposed stock option grants.

The stock options issued under the 2008 Plan are typically "nonqualified" (as a tax matter), have a ten (10) year maximum life (term) and vest during the first four years following issuance at the rate of 25% on each anniversary date of their issuance. The Company accounts for its employee and affiliate employee stock option expense as compensation expense in the Company’s financial statements when the stock options are granted, as now required by applicable accounting principles. Share-based compensation cost is measured on the grant date, based on the fair value of the award calculated at that date, and is recognized over the requisite service period, which generally is the options' vesting period. Fair value is calculated using the Black-Scholes option pricing model.

At the 2009 Annual Meeting, the stockholders of SGRP approved the adoption of the proposed amendment to SGRP's 2008 Plan adding a new Section 12(a) thereto (the "Repricing Amendment"). For descriptions of the 2008 Plan, the Repricing Amendment and the reasons for such amendment, see "Proposal 3 – Approval of the Adoption of the Repricing Amendment to the 2008 Stock Compensation Plan" (pages 4 & 5) and "Stock Options and Purchase Plans" (pages 17 & 18) in SGRP's Proxy Statement for the 2009 Annual Meeting, as filed with the Securities and Exchange Commission on April 30, 2009.

The Repricing Amendment gives SGRP's Compensation Committee the full authority and complete flexibility from time to time to designate and modify (in its discretion) one or more of the outstanding awards (including their exercise and base prices and other components and terms) to (among other things) restore their intended values and incentives to their holders. However, the exercise price, base value or similar component (if equal to SGRP's full stock price at issuance) of any award cannot be lowered to an amount that is less than the Fair Market Value (as defined in the 2008 Plan) on the date of the applicable modification, and no modification can adversely affect an awardee's rights or obligations under an award without the awardee's consent. No further consent of SGRP's stockholders is required for any repricing or other modification of any award under the Repricing Amendment. The Repricing Amendment applies to all outstanding options and other awards, including those previously issued under predecessor plans.

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Based upon the Black-Scholes calculation, share-based compensation expense related to employee and non-employee stock option grants totaled $270,000 and $250,000 for the nine months ended September 30, 2011 and 2010, respectively. The unamortized expense as of September 30, 2011, was approximately $905,000 for employee and non-employee outstanding stock option grants. The impact of the total share-based compensation expense on basic/diluted earnings per share was $0.01 for both the nine months ended September 30, 2011 and 2010.

On March 10, 2011, SGRP's Compensation Committee authorized an award of 100,000 shares of restricted SGRP common stock as additional compensation to Gary S. Raymond, the Company's Chief Executive Officer and President. The restricted shares vest 20,000 shares a year over the next five (5) years, starting on March 10, 2012 and continuing through March 10, 2016, provided Mr. Raymond continues to be so employed by the Company on the applicable vesting date. If Mr. Raymond leaves such employment, he will lose his right to receive any unvested shares. The compensation expense related to these restricted shares will be amortized by the Company over the five (5) year vesting period starting April 1, 2011. The Company recorded a compensation expense of $23,400 for the period ended September 30, 2011, for these restricted shares.

For more information respecting the Company's stock option and compensation plans, please see "Stock Compensation Plans" in SGRP's Proxy Statement for its 2011 meeting of stockholders as filed with the SEC on May 2, 2011.

9. Customer Deposits

Customer deposits at September 30, 2011, were $157,000 ($76,000 from domestic operations and $81,000 from international operations) compared to $471,000 at December 31, 2010 ($139,000 from domestic operations and $332,000 from international operations).

10. Commitments and Contingencies

International Commitments

Certain of the Company's international subsidiaries are profitable, while others are operating at a loss. In the event certain subsidiaries have continued losses, the Company may be required (by contract or to preserve its investment) to make additional cash infusions into those subsidiaries.

Legal Matters

Longstanding litigation with Safeway Inc. ("Safeway") concluded in August 2010. On October 24, 2001, Safeway filed a complaint against PIA Merchandising Co., Inc. ("PIA Co."), a wholly-owned subsidiary of SPAR Group, Inc. ("SGRP"), Pivotal Sales Company ("Pivotal"), a wholly-owned subsidiary of PIA Co., and SGRP in Alameda County (California) Superior Court, case no. 2001028498. Safeway's claims, as subsequently amended, alleged causes of action for breach of contract and breach of implied contract. PIA Co. and Pivotal filed cross-claims against Safeway, including causes of action for breach of contract and interference with economic relationships. The case proceeded to trial by jury. On May 26, 2006, the jury returned a verdict that awarded certain damages on different claims to PIA Co. and Pivotal and awarded certain damages to Safeway, resulting in a net award of $1,307,700 to Pivotal. Judgment was entered in favor of Pivotal and against Safeway on August 14, 2006, for $1,307,700. A subsequent order awarded Pivotal certain court costs totaling $33,725.

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SPAR Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
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Thereafter, both sides filed appeals. On May 27, 2010, the California Court of Appeal issued a decision affirming the judgment in full. All appellate proceedings concluded on July 28, 2010. On August 2, 2010, Safeway tendered, and the Company accepted, payment of $1,888,000 in full payment of the judgment.

In addition to the above, the Company is a party to various other legal actions and administrative proceedings arising in the normal course of business. In the opinion of the Company's management, disposition of these other matters are not anticipated to have a material adverse effect on the Company or its estimated or desired assets, business, capital, cash flow, credit, expenses, financial condition, income, liabilities, liquidity, locations, marketing, operations, prospects, sales, strategies, taxation or other achievement, results or condition.

11. Acquisition and Purchase of Interest in Subsidiaries

In March 2010, the Company established a new Canadian subsidiary, SPAR Wings & Ink Company ("SWI") specifically to expand its merchandising and marketing services throughout Canada. On April 1, 2010, with the approval of SGRP's directors, SWI acquired substantially all of the business, customer contracts, receivables, work-in progress, other assets and certain liabilities of 2078281 Ontario Limited, an Ontario merchandising and marketing company doing business as Wings & Ink (the "Seller"). The Company, at closing, also hired substantially all of the Seller's employees including offering consulting contracts to the principals of the Seller.

In return for the purchase of such assets and assumed liabilities, at closing SWI compensated the Seller through 1) a cash payment of $500,000 Canadian dollars ("CAD"), 2) issued a $75,000 CAD interest bearing promissory note payable over an 18 month period and 3) placed $50,000 in escrow for a 12 month period and 4) assumed $446,000 CAD of liabilities.

The Company has completed its valuation of the fair value and allocation for the assets acquired and liabilities assumed and has recorded the following (in US dollars):

Accounts Receivable	$644,000
Equipment	2,000
Customer contracts	426,000
	$1,072,000

The Company is amortizing the customer contracts of $426,000 on a straight line basis over 5 years. The net book value at September 30, 2011, and December 31, 2010 was approximately $294,000 and $362,000, respectively. Amortization expense for the nine months ending September 30, 2011, was approximately $68,000.

SWI also agreed to pay an earn out to the principals of the Seller based on SWI achieving certain revenue and gross profit margin levels of the acquired business for each of the next two 12 month periods. The earn out is based on revenue and gross profit margins exceeding certain agreed upon base levels, if achieved, the principles will be paid one third of the excess gross profit dollars in each of the two 12 month periods. The Company has not recorded a contingent liability as it is unlikely these revenue and gross margin targets will be met.

In September 2010, the Company purchased the remaining 49% ownership in its India subsidiary at a cost of $90,000 and in July 2011 the Company then entered into an agreement with KROGNOS Integrated Marketing Services Private Limited, to sell 49% ownership in the India subsidiary at a price of $90,000.

In August 2011, the Company expanded its operations in North America by entering into an agreement with Grupo TODOPROMO to create a new subsidiary in Mexico. The new subsidiary is called SPAR TODOPROMO, SAPI, de CV., began operations in September 2011 and is owned 51% by SPAR and 49% by Grupo TODOPROMO (Grupo). The Company's total investment in Mexico is $702,000 which consists of $2,000 in capital and $700,000 paid to Grupo for intangible assets. $400,000 was paid in September 2011 and the balance is payable in 2012. The company has recorded the $700,000 as an intangible asset. The allocation of the intangible asset between identifiable intangibles and goodwill is expected to be completed by December 31, 2011.

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In August 2011, the Company entered into an agreement with two companies in Turkey (NDS TANITIM DANIŞMANLIK HİZMETLERİ and GIDA TEKSTİL TURİZM PAZARLAMA TİCARET LİMİTED ŞİRKETİ) to reestabli operations in this market. The agreement established a new subsidiary, SPAR NDS, owned 51% by the Company and 49% by the Turkish companies noted above. The new subsidiary is scheduled to start operations in November 2011. The Company's total investment in Turkey is approximately $86,000

In July 2011, the Company's subsidiary in China, SPAR (Shanghai) Marketing Management Company Ltd ("SPAR Shanghai") entered into an agreement with Beijing DSI Management Consulting Company Ltd. ("DSI"), creating a new subsidiary in order to expand the Company's operations throughout the People's Republic of China. The new subsidiary is called SPAR DSI Human Resource Company ("SPAR DSI"), is owned 51% by SPAR Shanghai and 49% by DSI and is expected to be operational in November 2011.

12. Geographic Data

The Company operates in the same single business segment (e.g., merchandising and marketing services) in both its Domestic Merchandising Services Division and its International Merchandising Services Division. The Company uses the same metrics to measure the performance of both its domestic and international divisions. The primary measurement utilized by management is operating profits, historically the key indicator of long-term growth and profitability, as the Company is focused on reinvesting the operating profits of each of its international subsidiaries back into its local markets in an effort to improve market share and continued expansion efforts. Set forth below are summaries (in thousands) of the Company's net revenues from its United States subsidiaries (i.e., the Domestic Merchandising Services Division) and from its international (non-U.S.) subsidiaries (i.e., the International Merchandising Services Division), net revenue from certain international subsidiaries as a percent of consolidated net revenue, operating income (loss) and long lived assets by geographic area for 2011 and 2010, respectively:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net revenues:				
United States	$8,734	$9,044	$27,621	$26,503
International	8,830	6,630	22,304	17,912
Total net revenues	$17,564	$15,674	$49,925	$44,415

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011		2010		2011		2010	
International net revenue detail:		% of consolidated net revenue		% of consolidated net revenue		% of consolidated net revenue		% of consolidated net revenue
Australia	$2,307	13.1 %	$1,788	11.4 %	$6,226	12.5 %	$4,918	11.1 %
Canada	1,509	8.6	2,059	13.1	4,607	9.2	4,748	10.7
South Africa	1,325	7.5	612	3.9	2,603	5.2	1,608	3.6
Japan	1,185	6.8	1,143	7.3	3,052	6.1	2,988	6.7
All Others	2,504	14.3	1,028	6.6	5,816	11.7	3,650	8.2
	$8,830	50.3 %	$6,630	42.3 %	$22,304	44.7 %	$17,912	40.3 %

Total international revenue

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Notes to Consolidated Financial Statements
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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Operating income (loss):				
United States	$341	$515	$1,558	$1,640
International	60	(150)	(203)	(460)
Total operating income	$401	$365	$1,355	$1,180

	September 30, 2011	December 31, 2010
Long lived assets:		
United States	$2,235	$2,231
International	1,549	657
Total long lived assets	$3,784	$2,888

13. Supplemental Balance Sheet Information (in thousands)

	September 30, 2011	December 31, 2010
Accounts receivable, net, consists of the following:		
Trade	$9,926	$9,846
Unbilled	2,548	3,914
Non-trade	323	382
	12,797	14,142
Less allowance for doubtful accounts	101	143
Accounts receivable, net	$12,696	$13,999

	September 30, 2011	December 31, 2010
Property and equipment, net, consists of the following:		
Equipment	$7,819	$7,893
Furniture and fixtures	530	541
Leasehold improvements	250	250
Capitalized software development costs	4,099	3,518
	12,698	12,202
Less accumulated depreciation and amortization	11,171	10,750
Property and equipment, net	$1,527	$1,452

	September 30, 2011	December 31, 2010
Accrued expenses and other current liabilities consist of the following:		
Accrued salaries payable	$966	$708
Accrued accounting and legal expense	209	266
Other	1,323	1,759

Accrued expenses and other current liabilities	$2,498	$2,733

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14. Foreign Currency Rate Fluctuations

The Company has foreign currency exposure with its international subsidiaries. In both 2011 and 2010, these exposures are primarily concentrated in the Australian Dollar, Canadian Dollar and Japanese Yen. International revenues for the nine months ended September 30, 2011 and 2010 were $22.3 million and $17.9 million, respectively. The international division reported net losses of approximately $332,000 and $558,000 for the nine months ended September 30, 2011 and 2010, respectively.

In those countries where the Company had risk for foreign currency exposure, the total assets were $6.9 million and total liabilities were $4.8 million based on exchange rates at September 30, 2011.

15. Interest Rate Fluctuations

The Company is exposed to market risk related to the variable interest rate on its lines of credit, both in its United States subsidiaries (i.e., the Domestic Merchandising Services Division) and in its International (non-U.S.) subsidiaries (i.e., the International Merchandising Services Division). At September 30, 2011, the Company's outstanding lines of credit and other debt totaled approximately $4.4 million, as noted in the table below (in thousands):

Location	Variable Interest Rate (1)	US Dollars (2)
United States	4.75%	$3,782
International	0.1% -10.24%	612
		$4,394

(1) Based on interest rate at September 30, 2011.
(2) Based on exchange rate at September 30, 2011.

Based on the 2011 average outstanding borrowings under variable-rate debt, a one-percentage point increase in interest rates would negatively impact pre-tax earnings and cash flows for the nine months ended September 30, 2011 by approximately $23,000.

16. Recently Issued Accounting Standards

In June 2011, the FASB issued ASU No. 2011-05, “Comprehensive Income.” This ASU intends to enhance comparability and transparency of other comprehensive income components. The guidance provides an option to present total comprehensive income, the components of net income and the components of other comprehensive income in a single continuous statement or two separate but consecutive statements. This ASU eliminates the option to present other comprehensive income components as part of the statement of changes in shareowners’ equity. The provisions of this ASU will be applied retrospectively for interim and annual periods beginning after December 15, 2011. Early application is permitted. We are currently evaluating the impact of this new ASU.

In September 2011, the FASB issued ASU No, 2001-07, “Goodwill and Other Intangible Assets”. This ASU is intended to simplify goodwill impairment testing by adding a qualitative review step to assess whether the required quantitative

impairment analysis that exists today is necessary. The amended guidance permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. The amended guidance is effective beginning in 2012, however, with earlier adoption permitted. The Company intends to apply the updated guidance to its 2012 annual impairment test. The adoption of this update is not expected to have a significant impact on the Company's consolidated financial statements.

SPAR Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
(unaudited) (continued)

17. Taxes

In July 2006, the FASB issued an interpretation, Accounting for Uncertainty in Income Taxes, now codified as ASC Topic 740, which detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements. Tax positions must meet a more-likely-than-not recognition threshold and requires that interest and penalties that the tax law requires to be paid on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the return and the tax benefit recognized in the financial statements. The Company's policy is to record this interest and penalties as additional tax expense. The Company's tax reserves at September 30, 2011, and December 31, 2010 totaled $43,000, for potential domestic state tax and federal tax liabilities.

SPAR and its subsidiaries file numerous consolidated, combined and separate company income tax returns in the U.S. Federal jurisdiction and in many U.S. state and foreign jurisdictions. With few exceptions, SPAR is subject to U.S. Federal, state and local income tax examinations for the years 2005 through the present. However, tax authorities have the ability to review years prior to the position taken by the Company to the extent that SPAR utilized tax attributes carried forward from those prior years.

18. Reclassifications

Certain reclassifications have been made to the 2010 financial statements to conform to the 2011 presentation.

SPAR Group, Inc. and Subsidiaries

Item 2. Management's Discussion and Analysis of Financial Condition, Results of Operations, Liquidity and Capital Resources

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q for the nine months ended September 30, 2011 (this "Quarterly Report"), of SPAR Group, Inc. ("SGRP", and together with its subsidiaries, the "SPAR Group" or the "Company"), include "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act", and together with the Securities Act, the "Securities Laws"), including, in particular and without limitation, the discussions respecting net revenues from significant clients, significant chain work and international joint ventures, federal taxes and net operating loss carry forwards, commencement of operations and future funding of international joint ventures, credit facilities and covenant compliance, cost savings initiatives, liquidity and sources of cash availability in this "Management's Discussion and Analysis of Financial Condition, Results of Operations, Liquidity and Capital Resources". Such forward looking statements also are included in SGRP's Annual Report on Form 10-K for the fiscal year ended December 31, 2010, as filed with the Securities and Exchange Commission (the "SEC") on March 15, 2011 (its "Annual Report"), including (without limitation) the statements contained in the discussions under the headings “Business”, “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations”. You can identify forward-looking statements in such information by the Company's use of terms such as "may", "will", "expect", "intend", "believe", "estimate", "anticipate", "continue" or similar words or variations or negatives of those words. You should carefully consider all such information and the other risks and cautions noted in this Quarterly Report, the Company's Annual Report and the Company's other filings under applicable Securities Laws (including this Quarterly Report and the Company's Annual Report, each a "SEC Report") that could cause the Company's actual assets, business, capital, cash flow, credit, expenses, financial condition, income, liabilities, liquidity, locations, marketing, operations, prospects, sales, strategies, taxation or other achievement, results, risks or condition to differ materially from those anticipated by the Company and described in the information in the Company's forward-looking statements, whether express or implied, as the Company's anticipations are based upon the Company's plans, intentions and best estimates and (although the Company believe them to be reasonable) involve known and unknown risks, uncertainties and other factors that could cause them to fail to occur or be realized or to be materially and adversely different from those the Company anticipated.

Although the Company believes that its plans, intentions and estimates reflected or implied in such forward-looking statements are reasonable, the Company cannot assure you that such plans, intentions or estimates will be achieved in whole or in part, that the Company has identified all potential risks, or that the Company can successfully avoid or mitigate such risks in whole or in part. You should carefully review the risk factors described in this Quarterly Report and the Company's Annual Report (See Item 1A – Risk Factors) and any other cautionary statements contained or incorporated by reference in this Quarterly Report, the Company's Annual Report or other SEC Report. All forward-looking and other statements attributable to the Company or persons acting on its behalf are expressly subject to and qualified by all such risk factors and other cautionary statements.

You should not place undue reliance on the Company's forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond its control. The Company's forward-looking statements are based on the information currently available to it and speak only as of September 30, 2011 (in the case of this Quarterly Report), December 31, 2010 (in the case of the Company's Annual Report) or other referenced date or, in the case of forward-looking statements contained in or incorporated by reference from another SEC Report, as of the date of or other date referenced in the SEC Report that

includes such statement. New risks and uncertainties arise from time to time, and it is impossible for the Company to predict these matters or how they may arise or affect the Company. Over time, the Company's actual assets, business, capital, cash flow, credit, expenses, financial condition, income, liabilities, liquidity, locations, marketing, operations, prospects, sales, strategies, taxation or other achievements, results, risks or condition will likely differ from those expressed or implied by the Company's forward-looking statements, and such difference could be significant and materially adverse to the Company and the value of your investment in the Company's Common Stock.

SPAR Group, Inc. and Subsidiaries

The Company does not intend or promise, and the Company expressly disclaims any obligation, to publicly update or revise any forward-looking statements, risk factors or other cautionary statements (in whole or in part), whether as a result of new information, future events or recognition or otherwise, except as and to the extent required by applicable law.

GENERAL

SPAR Group, Inc., ("SGRP"), and its subsidiaries (together with SGRP, the "SPAR Group" or the "Company"), is a diversified international merchandising and marketing services company and provides a broad array of services worldwide to help companies improve their sales, operating efficiency and profits at retail locations. The Company provides its merchandising and other marketing services to manufacturers, distributors and retailers worldwide, primarily in mass merchandisers, office supply, grocery, drug store and other chains, and independent, convenience and electronics stores. The Company also provides furniture and other product assembly services in stores, homes and offices. Today the Company currently operates in 9 countries that encompass approximately 46% of the total world population through operations in the United States, Canada, Japan, South Africa, India, Romania, China, Australia and Mexico.

An Overview of the Merchandising and Marketing Services Industry

According to industry estimates over two billion dollars is spent annually in the United States alone on retail merchandising and marketing services. The merchandising and marketing services industry includes manufacturers, retailers, food brokers and professional service merchandising companies. Merchandising services primarily consist of regularly scheduled, special project and other product services provided at the store level, and the Company may be engaged by either the retailer or the manufacturer. Those services may include restocking and adding new products, removing spoiled or outdated products, resetting categories "on the shelf" in accordance with client or store schematics, confirming and replacing shelf tags, setting new sale or promotional product displays and advertising, replenishing kiosks, providing in-store event staffing, and providing assembly services in stores, homes and offices. Other merchandising services include whole store or departmental product sets or resets, including new store openings, new product launches and in-store demonstrations, special seasonal or promotional merchandising, focused product support and product recalls. The Company believes that merchandising and marketing services add value to retailers, manufacturers and other businesses and enhance sales by making a product more visible and more available to consumers.

Historically, retailers staffed their stores as needed to provide these services to ensure, that manufacturers' inventory levels, the advantageous display of new items on shelves, and the maintenance of shelf schematics and product placement were properly merchandised. However retailers, in an effort to improve their margins, decreased their own store personnel and increased their reliance on manufacturers to perform such services. Initially, manufacturers attempted to satisfy the need for merchandising and marketing services in retail stores by utilizing their own sales representatives. Additionally, retailers also used their own employees to merchandise their stores to satisfy their own merchandising needs. However, both the manufacturers and the retailers discovered that using their own sales representatives and employees for this purpose was expensive and inefficient.

Manufacturers and retailers have been, and SPAR Group believes they will continue outsourcing their merchandising and marketing service needs to third parties capable of operating at a lower cost by (among other things) serving multiple manufacturers simultaneously. The Company also believes that it is well positioned, as a domestic and international merchandising and marketing services company, to more effectively provide these services to retailers,

manufacturers and other businesses around the world.

Another significant trend impacting the merchandising and marketing services business is the tendency of consumers to make product purchase decisions once inside the store. Accordingly, merchandising and marketing services and in-store product promotions have proliferated and diversified. Retailers are continually re-merchandising and re-modeling entire stores in an effort to respond to new product developments and changes in consumer preferences. We estimate that these activities have increased in frequency over the last five years. Both retailers and manufacturers are seeking third parties to help them meet the increased demand for these labor-intensive services.

In addition, the consolidation of many retailers has created opportunities for third party merchandisers when an acquired retailer's stores are converted to the look and format of the acquiring retailer. In many cases, stores are completely remodeled and re-merchandised after a consolidation.

SPAR Group believes the current trend in business toward globalization fits well with its expansion model. As companies expand into foreign markets they will need assistance in merchandising or marketing their products. As evidenced in the United States, retailer and manufacturer sponsored merchandising and marketing programs are both expensive and inefficient. The Company also believes that the difficulties encountered by these programs are only exacerbated by the logistics of operating in foreign markets. This environment has created an opportunity for the Company to exploit its internet, hand-held and smart phone-based technology and business model worldwide.

The Company's Domestic and International Geographic Divisions:

In order to cultivate foreign markets and expand the Company's merchandising and marketing services business outside of the United States, modify the necessary systems and implement its business model worldwide, and insure a consistent approach to its merchandising and marketing efforts worldwide, and even though it operates in a single business segment (merchandising and marketing services), the Company has divided its world focus into two geographic areas, the United States, which is the sales territory for its Domestic Merchandising Services Division, and international (i.e., all locations outside the United States), which are the sales territories for its International Merchandising Services Division. To that end, the Company also (1) provides and requires all of its locations to use its Internet based operating, scheduling, tracking and reporting systems (including language translations, ongoing client and financial reports and ongoing IT support), (2) provides and requires all of its locations to comply with the Company's financial reporting and disclosure controls and procedures, (3) provides accounting and auditing support and tracks and reports certain financial and other information separately for those two divisions, and (4) has management teams in its corporate offices responsible for supporting and monitoring the management, sales, marketing and operations of each of the Company's international subsidiaries and maintaining consistency with the Company's other subsidiaries worldwide.

Each of these divisions provides merchandising and other marketing services primarily on behalf of consumer product manufacturers and retailers at mass merchandisers, drug store chains, convenience and grocery stores in their respective territories. SPAR Group Inc.'s clients include the makers and distributors of home entertainment, general merchandise, health and beauty care, consumer goods and food products in their respective territories.

SPAR Group has provided merchandising and other marketing services in the United States since the formation of its predecessor in 1979 and outside the United States since it acquired its first international subsidiary in Japan in May of 2001. Today the Company currently conducts its business through its domestic and international divisions in 9 territories around the world (listed in the table below) that encompass approximately 46% of the total world population.

SPAR Group, Inc. and Subsidiaries

The Company's international business in each territory outside the United States is conducted through a foreign subsidiary incorporated in its primary territory. The primary territory (together with each additional territory in which it conducts its business), establishment date (which may include predecessors), the percentage of the Company's equity ownership, and the principal office location for its US (domestic) subsidiaries and each of its foreign (international) subsidiaries is as follows:

Primary Territory (+ additional Territory)	Date Established	SGRP Percentage Ownership	
Purchases of property and equipment	(2,055)	(3,402)	(873)
Net cash used in investing activities	(2,055)	(3,402)	(873)
CASH FLOWS FROM FINANCING ACTIVITIES			
(Payments on) proceeds from factor borrowing, net	(1,707)	1,843	229
Exercise of stock options		50	
Purchase of treasury stock	(34)	(257)	
Payment of taxes on restricted stock units	(530)	(870)	(225)
Payment of taxes on net settled options exercised		(653)	
Exercise of warrants		653	
Net cash (used in) provided by financing activities	(2,271)	766	4
NET CHANGE IN CASH AND CASH EQUIVALENTS	6,280	(6,785)	9,730
CASH AND CASH EQUIVALENTS, at beginning of year	6,410	13,195	3,465
CASH AND CASH EQUIVALENTS, at end of year	$ 12,690	$ 6,410	$ 13,195

The accompanying notes are an integral part of these financial statements.

JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Business Description and Basis of Presentation

Our principal business activity involves the design, development and worldwide marketing of apparel products. Our primary current operating subsidiary is Joe's Jeans Subsidiary Inc., or Joe's Jeans Subsidiary. All significant inter-company transactions have been eliminated. We operate in two primary business segments: Wholesale and Retail. Our Wholesale segment is comprised of sales to retailers, specialty stores and distributors and includes revenue from licensing agreements and records expenses from marketing, sales, distribution and customer service departments. Also, some international sales are made directly to wholesale customers who operate retail stores. Our Retail segment is comprised of sales to consumers through full-price retail stores, outlet stores and through the *www.joesjeans.com/shop* internet site. We opened our first full price retail store in October 2008 in Chicago, Illinois and currently operate five full price retail stores and 17 outlet stores in outlet centers around the country. Our Corporate and other is comprised of expenses of our corporate operations, which include the executive, finance, legal, and human resources departments, design and production. Our fiscal year end is November 30. Each fiscal year, as presented, is 52 weeks.

We, along with our Joe's Subsidiary, JD Holdings, Inc., or JD Holdings, and Joseph Dahan, the sole stockholder of JD Holdings, entered into a definitive Agreement and Plan of Merger on February 6, 2007, as amended on June 25, 2007, or the Merger Agreement. JD Holdings primary assets included all rights, title and interest in all intellectual property, including the trademarks, related to the Joe's®, Joe's Jeans and JD brand and marks, or the Joe's Brand. JD Holdings was the successor to JD Design, the entity from whom we licensed the Joe's Brand. The license agreement terminated automatically upon completion of the merger. We acquired JD Holdings in order to acquire the Joe's Brand which allowed us to expand our product offerings and the brand in the marketplace, including opening branded retail stores and entering into licenses for additional product categories.

Under the terms and subject to the conditions set forth in the Merger Agreement, on October 25, 2007, we completed the merger. In connection with the merger, Joe's Subsidiary merged with and into JD Holdings, with Joe's Subsidiary as the surviving entity. In addition, we issued 14,000,000 shares of our common stock, made a cash payment of $300,000 to JD Holdings in exchange for all of its outstanding shares and incurred $269,000 of other costs related to the merger. As a result of the merger, we now own all outstanding stock of JD Holdings and all rights, title and interest in the Joe's Brand. Upon completion of the merger, on October 25, 2007, Mr. Dahan became one of our officers, directors and greater than 10 percent stockholder and the Employment Agreement and Investor Rights Agreement became effective.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Revenue Recognition

Wholesale revenues are recorded on the accrual basis of accounting when title transfers to the customer, which is typically at the shipping point. We record estimated reductions to revenue for

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

customer programs, including co-op advertising, other advertising programs or allowances, based upon a percentage of sales. We also allow for returns based upon pre-approval or in the case of damaged goods. Such returns are estimated based on historical experience and an allowance is provided at the time of sale.

Retail store revenue is recognized net of estimated returns at the time of sale to consumers. E-commerce sales of products ordered through our retail internet site known as www.joesjeans.com are recognized upon estimated delivery and receipt of the shipment by the customers. E-commerce revenue is also reduced by an estimate of returns. Retail store revenue and E-commerce revenue exclude sales taxes. Revenue from licensing arrangements are recognized when earned in accordance with the terms of the underlying agreements, generally based upon the higher of (a) contractually guaranteed minimum royalty levels; and (b) estimates of sales and royalty data received from our licensees. Payments received in consideration of the grant of a license or advanced royalty payments are recognized ratably as revenue over the term of the license agreement and are reflected under the caption of "Deferred Licensing Revenue" on the Consolidated Balance Sheets. The revenue recognized ratably over the term of the license agreement will not exceed royalty payments received. The unrecognized portion of the upfront payments are included in deferred royalties and accrued expenses depending on the long or short term nature of the payments to be recognized. There were no advanced payments under our licensing agreements during our fiscal year ended November 30, 2011 and 2010.

Accounts Receivable, Due To Factor and Allowance for Customer Credits and Doubtful Allowances

We evaluate our ability to collect on accounts receivable and charge-backs (disputes from the customer) based upon a combination of factors. Whether a receivable is past due is based on how recently payments have been received and in certain circumstances where we are aware of a specific customer's inability to meet its financial obligations (e.g., bankruptcy filings, substantial downgrading of credit sources). A specific reserve for bad debts is taken against amounts due to reduce the net recognized receivable to the amount reasonably expected to be collected. Amounts are charged off against the reserve once it is established that amounts are not likely to be collected. We recognize reserves for charge-backs based on our historical collection experience. See "Note 3 Accounts Receivable, Inventory Advances and Due to Factor" for further discussion.

Inventory

Inventory is valued at the lower of cost or market with cost determined by the first-in, first-out method. Inventory consists of finished goods, work-in-process and raw materials. We continually evaluate our inventories by assessing slow moving current product. Market value of non-current inventory is estimated based on historical sales trends for this category of inventory for individual product lines, the impact of market trends, an evaluation of economic conditions and the value of current orders relating to future sales of this type of inventory. Inventory reserves establish a new cost basis for inventory. Such reserves are not reversed until the related inventory is sold or otherwise disposed. Costs capitalized in inventory include the purchase price of raw materials, contract labor and finished goods, plus in-bound transportation costs and import fees and duties. During the third quarter of fiscal 2011, we wrote down certain finished goods inventory by $1,620,000, representing the lower of cost or market adjustment.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

Costs of Goods Sold

Costs of goods sold include product, freight in, freight out, inventory reserves, inventory markdowns and other various charges.

Selling, General and Administrative Expenses

Selling, general and administrative expenses include salaries and benefits, travel and entertainment, professional fees, advertising, marketing, sample expenses, stock based compensation expenses, facilities, fulfillment and distribution costs and compensation payments made in connection with the earn-out consideration.

Earnings Per Share

Basic earnings per share, or EPS, is computed using the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period except for periods of net loss for which no common share equivalents are included because their effect would be anti-dilutive. Dilutive common equivalent shares consist of common stock issuable upon exercise of stock options, restricted stock and restricted stock units using the treasury stock method.

Advertising Costs

Advertising costs are charged to expense as incurred, or, in the case of media ads, upon first airing. Brochures and catalogues are capitalized and amortized over their expected period of future benefits, which is typically twelve months or less.

Advertising and tradeshow expenses included in selling, general and administrative expenses were approximately $4,025,000, $2,368,000 and $2,462,000 for fiscal 2011, 2010 and 2009, respectively.

Financial Instruments

The fair values of our financial instruments (which consist of cash, accounts receivable, accounts payable, due to factor and notes payable) do not differ materially from their recorded amounts because of the relatively short period of time between origination of the instruments and their expected realization. We do not hold or have any obligations under financial instruments that possess off-balance sheet credit or market risk.

Impairment of Long-Lived Assets and Intangibles

We assess the impairment of long-lived assets, identifiable intangibles and goodwill annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important that could trigger an impairment review other than on an annual basis include the following:

- A significant underperformance relative to expected historical or projected future operating results;

- A significant change in the manner of the use of the acquired asset or the strategy for the overall business; or

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

A significant negative industry or economic trend.

When we determine that the carrying value of long-lived assets may not be recoverable based upon the existence of one or more of the aforementioned factors, impairment is measured based on a projected discounted cash flow method using a discount rate determined by management. These cash flows are calculated by netting future estimated sales against associated merchandise costs and other related expenses such as payroll, occupancy and marketing.

During the third quarter of fiscal 2011, we recorded store impairment charges of $1,144,000 related to two of our full price retail stores. Based on the operating performance of these stores, we believed that we could not recover the carrying value of property and equipment located at these stores.

In fiscal 2007, we acquired through merger JD Holdings, which included all of the goodwill and intangible assets goodwill related to the Joe's®, Joe's Jeans and JD® logo and marks. To date, we have not had to recognize any impairment related to the goodwill or intangible assets of our Joe's® brand. We have assigned an indefinite life to these intangible assets and therefore, no amortization expenses are expected to be recognized. However, we test the assets for impairment annually in accordance with our critical accounting policies.

Under the Financial Accounting Standards Board (FASB) Accounting Standards Codification, or ASC, we are required to evaluate goodwill and other indefinite lived intangible assets at least annually using a two-step process. The first step is to determine the fair value of each reporting unit and compare this value to its carrying value. If the fair value exceeds the carrying value, no further work is required and no impairment loss would be recognized. The second step is performed if the carrying value exceeds the fair value of the assets. The implied fair value of the reporting unit's goodwill or indefinite lived intangible assets must be determined and compared to the carrying value of the goodwill or indefinite lived intangible assets.

Our annual impairment testing date is September 30 of each year. For fiscal 2011 and 2010, we determined that there was no impairment of our goodwill or indefinite lived intangible assets.

Cash Equivalents

We consider all highly liquid investments that are both readily convertible into known amounts of cash and mature within 90 days from their date of purchase to be cash equivalents.

Concentration of Credit Risk

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of cash, cash equivalents, accounts receivable and amounts due from factor. We maintain cash and cash equivalents with various financial institutions. The policy is designed to limit exposure to any one institution. We perform periodic evaluations of the relative credit rating of those financial institutions that are considered in our investment strategy.

We do not require collateral for trade accounts receivable. However, we sell a portion of our accounts receivable to CIT Commercial Services, Inc., or CIT, on a non-recourse basis. In that instance, we are no longer at risk if the customer fails to pay. However, for accounts receivable that are not sold to CIT or sold on a recourse basis, we continue to be at risk if these customers fail to pay. We provide an allowance for estimated losses to be incurred in the collection of accounts receivable based upon the

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

aging of outstanding balances and other account monitoring analysis. The net carrying value approximates the fair value for these assets. Such losses have historically been within management's expectations. Uncollectible accounts are written off once collection efforts are deemed by management to have been exhausted.

For fiscal 2011, 2010 and 2009, sales to customers or customer groups representing greater than 10 percent of net sales are as follows:

	2011	2010	2009
Nordstrom, Inc.	25.5%	21.7%	20.2%
Macy's Inc.	*	11.0%	14.9%
Anthropologie	*	*	11.4%

* Less than 10%.

Our 10 largest customers and customer groups accounted for approximately 62 percent of our net sales during fiscal 2011. In addition, our international sales were $4,568,000, $6,233,000 and $5,719,000 in fiscal 2011, 2010 and 2009, respectively.

Stock-Based Compensation

We measure the cost of all employee stock-based compensation awards based on the grant date fair value of those awards and record that cost as compensation expense over the period during which the employee is required to perform service in exchange for the award (generally over the vesting period of the award). An entity may elect either an accelerated recognition method or a straight-line recognition method for awards subject to graded vesting based on a service condition, regardless of how the fair value of the award is measured. For all stock based compensation awards that contain graded vesting based on service conditions, we have elected to apply a straight-line recognition method to account for these awards.

Property and Equipment

Property and equipment are stated at the lower of cost or fair value in the case of impaired assets. Depreciation is computed on a straight-line basis over the estimated useful lives of the assets. Leasehold improvements are amortized over the lives of the respective leases or the estimated service lives of the improvements, whichever is shorter. Maintenance and repairs are charged to expense as incurred. Upon sale or retirement, the asset cost and related accumulated depreciation or amortization is removed from the accounts, and any related gain or loss is included in the determination of net income.

Income Taxes

We use the liability method of accounting for income taxes. Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates.

Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The likelihood of a material change in our expected realization of these assets

JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

depends on our ability to generate sufficient future taxable income. Our ability to generate enough taxable income to utilize our deferred tax assets depends on many factors, among which is our ability to deduct tax loss carry-forwards against future taxable income, the effectiveness of tax planning strategies and reversing deferred tax liabilities.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained upon examination by the taxing authorities, based upon the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based upon the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. Our policy is to recognize interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense.

Reclassifications

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

Other Recently Issued Financial Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued revised guidance for the accounting of transfers of financial assets. This guidance is intended to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. The adoption of this accounting guidance did not have a material impact on our financial position, results of operations or liquidity.

In June 2009, the FASB issued revised guidance for the accounting of variable interest entities, which replaces the quantitative-based risks and rewards approach with a qualitative approach that focuses on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. This accounting guidance also requires an ongoing reassessment of whether an entity is the primary beneficiary and requires additional disclosures about an enterprise's involvement in variable interest entities. The adoption of this accounting guidance did not have a material impact on our financial position, results of operations or liquidity.

In June 2011, the FASB issued guidance regarding the presentation of comprehensive income. The new standard requires the presentation of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The new standard also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented. The updated guidance is effective on a retrospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The adoption of this standard will only impact the presentation of our consolidated financial statements and will have no impact on the reported results.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

In May 2011, the FASB issued additional guidance on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. The updated guidance is effective on a prospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. We do not believe that adoption of this guidance will have a material impact on our financial position and results of operations.

In December 2010, the FASB issued an update to modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with the existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This accounting guidance will be effective for financial statements issued for fiscal years beginning after December 15, 2010, and interim periods within those fiscal years. Early adoption is not permitted. We do not believe that adoption of this guidance will have a material impact on our financial position and results of operations.

3. Accounts Receivable, Inventory Advances and Due to Factor

Historically, our primary method to obtain the cash necessary for operating needs has been through the sale of accounts receivable pursuant to factoring agreements and advances under inventory security agreements with our factor, CIT.

As a result of these agreements, amounts due to factor consist of the following (in thousands):

	November 30, 2011	November 30, 2010
Non-recourse receivables assigned to factor	$ 14,892	$ 13,571
Client recourse receivables	108	146
Total receivables assigned to factor	15,000	13,717
Allowance for customer credits	(2,498)	(2,967)
Net loan balance from factored accounts receivable	(10,857)	(10,013)
Net loan balance from inventory advances	(4,910)	(5,709)
Due to factor	$ (3,265)	$ (4,972)
Non-factored accounts receivable	$ 2,220	$ 3,263
Allowance for customer credits	(358)	$ (440)
Allowance for doubtful accounts	(320)	(449)
Accounts receivable, net of allowance	$ 1,542	$ 2,374

Of the total amount of receivables sold by us as of November 30, 2011 and November 30, 2010, we hold the risk of payment of $108,000 and $146,000, respectively, in the event of non-payment by the customers.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Accounts Receivable, Inventory Advances and Due to Factor (Continued)

Our Joe's Jeans Subsidiary is party to accounts receivable factoring agreement and an inventory security agreement with CIT. The accounts receivable agreement give us the ability to obtain cash by selling to CIT certain of its accounts receivable and the inventory security agreement give us the ability to obtain advances for up to 50 percent of the value of certain eligible inventory. The accounts receivables are sold for up to 85 percent of the face amount on either a recourse or non-recourse basis depending on the creditworthiness of the customer. CIT currently permits us to sell our accounts receivables at the maximum level of 85 percent and allows advances of up to $6,000,000 for eligible inventory. CIT has the ability, in its discretion at any time or from time to time, to adjust or revise any limits on the amount of loans or advances made to us pursuant to both of these agreements and to impose surcharges on our rates for certain of our customers. In addition, cross guarantees were executed by and among us and all of our parent and subsidiaries to guarantee each entity's obligations.

As of November 30, 2011, Joe's cash availability with CIT was approximately $1,134,000. This amount fluctuates on a daily basis based upon invoicing and collection related activity by CIT for the receivables sold. In connection with the agreements with CIT, certain assets are pledged to CIT, including all of the inventory, merchandise and/or goods, including raw materials through finished goods and receivables. However, our trademarks are not encumbered.

In May 2010, the parties amended the accounts receivable agreement to provide for a change in the factoring fees, an extension of the agreement and additional termination rights. The accounts receivable agreement may be terminated by CIT upon 60 days' written notice or immediately upon the occurrence of an event of default as defined in the agreement. The accounts receivable agreement may be terminated by us upon 60 days' written notice prior to June 30, 2012, or earlier provided that the minimum factoring fees have been paid for the respective period or CIT fails to fund us for five consecutive days. The inventory agreement may be terminated once all obligations are paid under both agreements or if an event of default occurs as defined in the agreement.

From June 1 to June 30, 2010, we paid to CIT a factoring rate of 0.6 percent to factor accounts which CIT bore the credit risk, subject to discretionary surcharges, and 0.4 percent for accounts which Joe's bore the credit risk. The interest rate associated with borrowings under the inventory lines and factoring facility is 0.25 percent plus the Chase prime rate. Beginning July 1, 2010, the factoring rate changed to 0.55 percent for accounts which CIT bears the credit risk, subject to discretionary surcharges, up to $40,000,000 of invoices factored, 0.50 percent over $40,000,000 of invoices factored and 0.35 percent for accounts which we bear the credit risk. The interest rate associated with borrowings under the inventory lines and factoring facility is 0.25 percent plus the Chase prime rate. As of November 30, 2011, the Chase prime rate was 3.25 percent.

In the event we need additional funds, we have also established a letter of credit facility with CIT to allow us to open letters of credit for a fee of 0.25 percent of the letter of credit face value with international and domestic suppliers, subject to availability. At November 30, 2011, we had four letters of credit outstanding in the aggregate amount of $650,000.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Inventories

Inventory is valued at the lower of cost or market with cost determined by the first-in, first-out method. Inventories consisted of the following (in thousands):

	November 30, 2011	November 30, 2010
Finished goods	$ 13,512	$ 23,347
Finished goods consigned to others	238	376
Work in progress	2,052	1,508
Raw materials	8,574	6,081
	24,376	31,312
Less allowance for obsolescence and slow moving items	(1,114)	(1,067)
	$ 23,262	$ 30,245

We recorded charges to our inventory reserve allowance of $128,000, $0 and $28,000 in fiscal 2011, 2010 and 2009, respectively.

5. Property and Equipment

Property and equipment consisted of the following (in thousands):

	Useful lives (years)	November 30, 2011	November 30, 2010
Computer and equipment	3 - 7	$ 1,753	$ 1,600
Furniture and fixtures	3 - 7	2,453	1,930
Leasehold improvements, primarily retail	5 - 10	4,001	4,437
		8,207	7,967
Less accumulated depreciation		(2,743)	(2,246)
Net property and equipment		$ 5,464	$ 5,721

Depreciation expenses aggregated $1,168,000, $843,000 and $536,000 for fiscal 2011, 2010 and 2009, respectively.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Income Taxes

The (benefit) provision for income taxes is as follows:

	Year ended (in thousands)		
	2011	**2010**	**2009**
Current:			
Federal	$ 24	$ 255	$ 1,828
State	195	231	955
	219	486	2,783
Deferred:			
Federal	260	2,158	1,506
State	(163)	312	(383)
	97	2,470	1,123
Change in valuation allowance			(20,291)
Total	$ 316	$ 2,956	$ (16,385)

Net deferred tax assets result from the following temporary differences between the book and tax basis of assets and liabilities:

	Year ended (in thousands)	
	2011	**2010**
Deferred tax assets:		
Current:		
Allowance for customer credits and doubtful accounts	$ 1,259	$ 1,542
Inventory valuation	717	477
Net benefit of net operating loss carryforwards	98	93
Stock compensation expense	19	21
Inventory capitalization	390	913
Other	161	179
Total current deferred taxes	$ 2,644	$ 3,225
Noncurrent:		
Property and equipment basis difference	$ (6)	$ (644)
Benefit of net operating loss carryforwards	13,599	14,015
Stock compensation expense	113	40
Deferred Rent	509	367
Other	(38)	1
Total noncurrent deferred tax assets	14,177	13,779
Deferred tax liabilities:		
Noncurrent:		

Long lived intangible asset	9,514	9,600
Total noncurrent deferred tax liabilities	9,514	9,600
Net noncurrent deferred tax assets	$ 4,663	$ 4,179

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Income Taxes (Continued)

A valuation allowance is required when it is more likely than not that all or a portion of a deferred tax asset will not be realized. Annually, management reassesses the need for a valuation allowance. Realization of deferred income tax assets is dependent upon taxable income in prior carryback years, estimates of future taxable income, tax planning strategies and reversals of existing taxable temporary differences. Based on our assessment of these items for fiscal 2011, 2010 and 2009, we determined that the deferred tax assets were more likely than not to be realized. Fiscal 2009 includes the reversal of a previously established valuation allowance of $20,291,000.

The reconciliation of the effective income tax rate to the federal statutory rate for the years ended is as follows:

	Year ended		
	2011	**2010**	**2009**
Computed tax provision (benefit) at the statutory rate	34.0%	35.0%	35.0%
State income tax	(2.0)%	6.4%	6.9%
Contingent consideration payments	(57.0)%	11.0%	7.0%
Change in valuation allowance			(249.5)%
Effect of uncertain tax positions	(1.5)%		
Sec 162 (m) limitation	(3.2)%		
Other adjustments	(0.4)%	0.8%	(0.8)%
Effective tax rate	(30.1)%	53.2%	(201.4)%

We are subject to U.S. federal income tax as well as income tax in multiple state jurisdictions. To the extent allowed by law, the tax authorities may have the right to examine prior periods where net operating losses were generated and carried forward, and make adjustments up to the amount of the net operating loss carryforward amount. We are no longer subject to U.S. federal and California income tax examinations by tax authorities for years prior to fiscal 2008. Our federal income tax return for fiscal 2009 is currently under examination by the Internal Revenue Service, or IRS. We do not expect that this examination will have a material effect on our financial statements or results of operations upon conclusion of examination. There are currently no other examinations pending with any other jurisdictions.

We had net operating loss carryforwards of $38,956,000 at the end of fiscal 2011 for federal tax purposes that will expire from fiscal 2018 through fiscal 2027. We also had $25,489,000 of net operating loss carryforwards available for California that will expire from fiscal 2017 through fiscal 2020.

Certain limitations may be placed on net operating loss carryforwards as a result of "changes in control" as defined in Section 382 of the Internal Revenue Code. In the event a change in control occurs, it will have the effect of limiting the annual usage of the carryforwards in future years. Additional changes in control in future periods could result in further limitations of our ability to offset taxable income. Management believes that certain changes in control have occurred which resulted in limitations on its net operating loss carryforwards, however, management has determined that these limitations will not impact the ultimate utilization of the net operating loss carryforwards.

As of November 30, 2011 and 2010, we provided a liability of $166,000 and $101,000, respectively, for unrecognized tax benefits related to various federal and state income tax matters. Included in the balance sheet at November 30, 2011 is $139,000, net of tax related benefits, that impact the effective

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Income Taxes (Continued)

income tax rate if recognized. The following presents a rollforward of its unrecognized tax benefits (in thousands):

Balance at December 1, 2009	$ 89
Decrease for tax positions taken during the prior period	(89)
Increase for tax positions taken during the current period	101
Balance at November 30, 2010	101
Increase for tax positions taken during the prior period	8
Increase for tax positions taken during the current period	57
Balance at November 30, 2011	$ 166

We recognize accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes in its statements of operations. For fiscal 2011 and 2010, we had approximately $16,000 and $0, respectively, for the payment of interest and penalties accrued at November 30, 2011 and 2010, respectively.

We do not expect any unrecognized tax benefit to reverse in fiscal 2012. However, in fiscal 2012, we expect $86,000 of the unrecognized tax benefits to be reclassified from an uncertain tax position liability to an income tax payable liability as a result of the ongoing Internal Revenue Service examination for 2009. We do not expect this reclassification to have an impact on the effective income tax rate.

7. Stockholders' Equity

Warrants

Historically, we have issued warrants in conjunction with various private placements of our common stock, and debt to equity conversions. As of November 30, 2011, all outstanding common stock warrants have been exercised or have expired. During fiscal 2010, 605,000 warrants were exercised and no warrants expired unexercised. During fiscal 2009, 187,500 warrants expired unexercised.

Stock Incentive Plans

In September 2000, we adopted the 2000 Director Stock Incentive Plan, or the 2000 Director Plan, under which nonqualified stock options were granted to members of our Board of Directors in lieu of cash director fees. After the adoption of the 2004 Stock Incentive Plan in June 2004, we no longer granted options pursuant to the 2000 Director Plan; however, the plan remains in effect for awards outstanding as of the adoption of the 2004 Stock Incentive Plan. As of November 30, 2011, options to purchase up to 93,290 shares of common stock remained outstanding under the 2000 Director Plan.

On June 3, 2004, we adopted the 2004 Stock Incentive Plan, or the 2004 Incentive Plan, and in October 2011, we adopted an Amended and Restated Stock Incentive Plan, or the Restated Plan, to update it with respect to certain provisions and changes in the tax code since its original adoption. Under the Restated Plan, the number of shares authorized for issuance is 6,825,000 shares of common stock. After the adoption of the Restated Plan in October 2011, we will no longer grant awards pursuant to the 2004 Incentive Plan; however, it remains in effect for awards outstanding as of the adoption of the Restated Plan. Under the Restated Plan, grants may be made to employees, officers,

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders' Equity (Continued)

directors and consultants under a variety of awards based upon underlying equity, including, but not limited to, stock options, restricted common stock, restricted stock units or performance shares. The Restated Plan limits the number of shares that can be awarded to any employee in one year to 1,250,000. The exercise price for incentive options may not be less than the fair market value of our common stock on the date of grant and the exercise period may not exceed ten years. Vesting periods, terms and types of awards are determined by the Board of Directors and/or our Compensation and Stock Option Committee, or Compensation Committee. The Restated Plan includes a provision for the acceleration of vesting of all awards upon a change of control as well as a provision that allows forfeited or unexercised awards that have expired to be available again for future issuance. Since fiscal 2008, we have issued both restricted common stock and restricted common stock units, or RSUs, to our officers, directors and employees pursuant to our various plans. The RSUs represent the right to receive one share of common stock for each unit on the vesting date provided that the employee continues to be employed by us. On the vesting date of the RSUs, we expect to issue the shares of common stock to each participant upon vesting and expect to withhold an equivalent number of shares at fair market value on the vesting date to fulfill tax withholding obligations. Any RSUs withheld or forfeited will be shares available for issuance in accordance with the terms of the Restated Plan.

The shares of common stock issued upon exercise of a previously granted stock option or a grant of restricted common stock or RSUs are considered new issuances from shares reserved for issuance in connection with the adoption of the various plans. We require that the option holder provide a written notice of exercise in accordance with the option agreement and plan to the stock plan administrator and full payment for the shares be made prior to issuance. All issuances are made under the terms and conditions set forth in the applicable plan. As of November 30, 2011, 6,825,000 shares remained available for issuance under the Restated Plan.

For all stock compensation awards that contain graded vesting with time-based service conditions, we have elected to apply a straight-line recognition method to account for all of these awards. For existing grants that were not fully vested at November 30, 2011, there was a total of $1,808,000 of stock based compensation expense recognized during fiscal 2011.

The following summarizes option grants, restricted common stock and RSUs issued to members of our Board of Directors for the fiscal years 2002 through fiscal 2011 (in actual amounts) for service as a member:

Granted as of:	November 30, 2011 Number of options	Exercise price
2002	40,000	$ 1.00
2002	31,496	$ 1.27
2003	30,768	$ 1.30
2004	320,000	$ 1.58
2005	300,000	$ 5.91
2006	450,000	$ 1.02

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders' Equity (Continued)

	Number of restricted shares isssued
2007	320,000
2008	473,455
2009	371,436
2010	131,828
2011	

Stock option activity in the aggregate for the periods indicated are as follows (in actual amounts):

	Options	Weighted average exercise price	Weighted average remaining contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at November 30, 2010	868,290	$ 3.73		
Granted				
Exercised				
Forfeited/expired				
Outstanding and exercisable at November 30, 2011	868,290	$ 3.73	3.1	$
Weighted average per option fair value of options granted during the year		N/A		

	Options	Weighted average exercise price	Weighted average remaining contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at November 30, 2009	3,226,046	$ 1.78		
Granted				
Exercised	(2,357,756)	1.08		
Forfeited/expired				
Outstanding and exercisable at November 30, 2010	868,290	$ 3.73	4.1	$ 97,251
Weighted average per option fair value of options granted during the year		N/A		

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at November 30, 2008	3,313,146	$ 1.76		
Granted				
Exercised				
Forfeited/expired	(87,100)	1.02		
Outstanding and exercisable at November 30, 2009	3,226,046	$ 1.78	4.7	$ 687,786
Weighted average per option fair value of options granted during the year		N/A		

The total intrinsic value of options exercised during the fiscal years ended November 30, 2011, 2010 and 2009 was $0, $2,720,000 and $0, respectively.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders' Equity (Continued)

Exercise prices for options outstanding and exercisable as of November 30, 2011 are as follows:

	Options Outstanding and Exercisable	
Exercise Price	**Number of shares**	**Weighted-Average Remaining Contractual Life**
$1.00 - $1.02	140,000	3.2
$1.27 - $1.30	53,290	1.2
$1.58 - $1.63	225,000	2.7
$5.91	450,000	3.5
	868,290	3.1

The following table summarizes stock option activity by plan.

	Total Number of Shares	**2004 Incentive Plan**	**2000 Director Plan**
Outstanding at November 30, 2010	868,290	775,000	93,290
Granted			
Exercised			
Forfeited / Cancelled			
Outstanding and exercisable at November 30, 2011	868,290	775,000	93,290
Outstanding at November 30, 2009	3,226,046	3,022,500	203,546
Granted			
Exercised	(2,357,756)	(2,247,500)	(110,256)
Forfeited / Cancelled			
Outstanding and exercisable at November 30, 2010	868,290	775,000	93,290
Outstanding at November 30, 2008	3,313,146	3,109,600	203,546
Granted			
Exercised			
Forfeited / Cancelled	(87,100)	(87,100)	
Outstanding and exercisable at November 30, 2009	3,226,046	3,022,500	203,546

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders' Equity (Continued)

A summary of the status of restricted common stock and RSUs as of November 30, 2010, and changes during the year ended November 30, 2011, are presented below:

				Weighted-Average Grant-Date Fair Value	
	Restricted Shares	Restricted Stock Units	Total	Restricted Shares	Restricted Stock Units
Outstanding at November 30, 2010	408,857	3,126,967	3,535,824	$ 0.86	$ 0.90
Granted	260,182	959,331	1,219,513	1.65	1.15
Issued	(204,429)	(1,085,780)	(1,290,209)	0.86	0.93
Cancelled		(457,790)	(457,790)		0.91
Forfeited					
Outstanding at November 30, 2011	464,610	2,542,728	3,007,338	$ 1.30	$ 0.98
Outstanding at November 30, 2009	691,903	4,773,979	5,465,882	$ 0.94	$ 0.84
Granted		131,828	131,828		1.77
Vested					
Issued	(283,046)	(1,128,318)	(1,411,364)	1.06	0.77
Cancelled		(478,517)	(478,517)		0.78
Forfeited		(172,005)	(172,005)		1.01
Outstanding at November 30, 2010	408,857	3,126,967	3,535,824	$ 0.86	$ 0.90
Outstanding at November 30, 2008	157,233	2,503,526	2,660,759	$ 1.59	$ 0.75
Granted	613,286	3,461,547	4,074,833	0.86	0.84
Vested	(78,616)		(78,616)	1.59	
Issued		(934,887)	(934,887)		0.66
Cancelled		(236,999)	(236,999)		0.68
Forfeited		(19,208)	(19,208)		0.70
Outstanding at November 30, 2009	691,903	4,773,979	5,465,882	$ 0.94	$ 0.84

As of November 30, 2011, there was $2,456,000 of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the 2004 Incentive Plan. In fiscal 2011, there were no options granted, 959,331 RSUs and 260,182 shares of restricted stock granted. In fiscal 2011, we issued 1,085,780 shares of our common stock to holders of RSUs, 204,429 shares of restricted stock and withheld or cancelled 457,790 RSUs.

Earnings Per Share

Earnings per share are computed using weighted average common shares and dilutive common equivalent shares outstanding. Potentially dilutive securities consist of outstanding options and warrants.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders' Equity (Continued)

A reconciliation of the numerator and denominator of basic earnings per share and diluted earnings per share is as follows:

	Year Ended (in thousands, except per share data)		
	November 30, 2011	November 30, 2010	November 30, 2009
Basic earnings per share computation:			
Numerator:			
Net (loss) income	$ (1,365)	$ 2,601	$ 24,520
Denominator:			
Weighted average common shares outstanding	64,001	62,362	60,053
(Loss) income per common share basic	$ (0.02)	$ 0.04	$ 0.41
Diluted earnings per share computation:			
Numerator:			
Net (loss) income	$ (1,365)	$ 2,601	$ 24,520
Denominator:			
Weighted average common shares outstanding	64,001	62,362	60,053
Effect of dilutive securities:			
Restricted shares, RSU's, options and warrants		2,143	1,068
Dilutive potential common shares	64,001	64,505	61,121
(Loss) income per common share dilutive	$ (0.02)	$ 0.04	$ 0.40

For fiscal 2011, currently exercisable options, unvested restricted shares and unvested RSUs in the aggregate of 3,875,628 have been excluded from the calculation of the diluted loss per share as their effect would have been anti-dilutive. For fiscal 2010 and 2009, currently exercisable options and warrants in the aggregate of 450,000, and 3,640,982, respectively, have been excluded from the calculation of diluted income per share because the exercise prices of such options and warrants were out-of-the-money.

Shares Reserved for Future Issuance

As of November 30, 2011, shares reserved for future issuance include (i) 868,290 shares of common stock issuable upon the exercise of stock options granted under the incentive plans; (ii) 2,542,728 shares of common stock issuable upon the vesting of RSUs; and (iii) an aggregate of 6,825,000 shares of common stock available for future issuance under the Restated Plan as of November 30, 2011.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Commitments and Contingencies

Operating Lease Obligations and Other Obligations Related to Operations

We lease certain equipment and office and retail space under separate lease arrangements. The leases generally contain renewal provisions. Equipment and office rental expenses under such leases for the years ended November 30, 2011, November 30, 2010 and November 30, 2009, were approximately $4,217,000, $2,755,000, and $1,408,000 , respectively.

In January 2010, we moved our headquarters and principal executive offices to a facility under a month-to-month arrangement with a third party who provides its product fulfillment, warehousing and distribution services. Under this arrangement commencing in January 2010, we paid a monthly fee of approximately $189,000 for allocated expenses associated with its use of office and warehouse space including its product fulfillment, warehousing and distribution services. Expenses under this arrangement and previous arrangements similar to this one were $2,748,000 and $2,668,000 for fiscal 2010 and 2009, respectively.

We lease retail store locations under operating lease agreements expiring on various dates through 2023 or 5 to 10 years from the rent commencement date. Some of these leases require us to make periodic payments for property taxes, utilities and common area operating expenses. Certain retail store leases provide for rents based upon the minimum annual rental amount and a percentage of annual sales volume, generally ranging from 6% to 8%, when specific sales volumes are exceeded. Some leases include lease incentives, rent abatements and fixed rent escalations, which are amortized and recorded over the initial lease term on a straight-line basis.

On January 8, 2010, we entered into an agreement to provide us with warehouse storage and fulfillment services and corporate office space on a month to month basis. Under the terms of the agreement, we paid on a per square foot basis for office and warehouse space along with an hourly billing rate for labor associated with the services provided by the landlord. The agreement could be cancelled by either party upon 30 days' written notice or if no storage or other services were performed for a period of 180 days. The agreement contained other customary terms and conditions related to the handling and storage of products, as well as the provision of services under the agreement. See below for further discussion regarding the termination of this agreement.

On November 22, 2010, we entered into a lease agreement to lease additional office and warehouse space at our current corporate offices that commenced on January 1, 2011, or the Lease Agreement. In connection with the Lease Agreement, we lease approximately 89,000 square feet which serves as our corporate headquarters and distribution center. In connection with the Lease Agreement, the previous agreement terminated and the landlord no longer provided certain fulfillment and distribution services for us.

We lease the office and warehouse space until December 31, 2013 and have one option to extend for an additional three year period. We pay gross monthly rent in the amount of $42,000. The Lease Agreement contains other customary terms and conditions related to the lease and condition of the premises, including a provision for a refundable security deposit in the amount of $114,000.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Commitments and Contingencies (Continued)

As of November 30, 2011, the future minimum rental payments under non-cancelable retail operating leases with lease terms in excess of one year were as follows (in thousands):

2012	$ 4,200
2013	4,502
2014	4,783
2015	4,936
2016	4,939
Thereafter	19,079
	$ 42,439

Advertising Commitments

From time to time, we enter into various agreements for short term billboard, taxi cab top, bus, other advertising spaces in various locations in and around New York and Los Angeles and for print advertising. However, we do not have any commitment to pay a minimum amount or any long term commitments for such advertising.

Letters of Credit

We had a contingent liability in the aggregate amount of $650,000 for four open letters of credit as of November 30, 2011.

Employment Agreement

After completion of the merger, we entered into an employment agreement for Mr. Dahan to serve as Creative Director for the Joe's Brand.

The initial term of employment is five years with automatic renewals for successive one year periods thereafter, unless terminated earlier in accordance with the agreement. Under the employment agreement, Mr. Dahan is entitled to an annual salary of $300,000 and other discretionary benefits that the Compensation Committee of the Board of Directors may deem appropriate in its sole and absolute discretion.

Under the terms of the employment agreement, we may terminate Mr. Dahan for cause or if he becomes disabled, as defined in the agreement. Should we terminate Mr. Dahan's employment for cause or disability, we would only be required to pay him through the date of termination. We may terminate Mr. Dahan's employment without cause at any time upon two weeks' notice, provided that we pay to him the present value of the annual salary amounts otherwise due to him for the remainder of the initial term of employment or any renewal term. Mr. Dahan may terminate his employment for good reason at any time with 30 days written notice. In the event that Mr. Dahan terminates his employment for good reason, then he will be entitled to the present value of the annual salary amounts otherwise due to him for the remainder of the term of employment. Further, Mr. Dahan may terminate his employment for any reason upon ten business days' notice and only be entitled to his salary as of the date of termination on a pro rata basis.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Commitments and Contingencies (Continued)

The employment agreement contains customary terms and conditions related to confidentiality of information, ownership by Joe's of all intellectual property, including future designs and trademarks, alternative dispute resolution and Mr. Dahan's duties and responsibilities to us and the Joe's Brand as Creative Director.

Investor Rights Agreement

Upon the closing of the merger, we also entered into an investor rights agreement. Pursuant to the investor rights agreement, we agreed to register for resale, on a periodic basis at the request of Mr. Dahan, the shares of common stock eligible for resale issued in connection with the merger. The shares of common stock issued as merger consideration become eligible for resale beginning on the six month anniversary of the closing date of the merger at an initial rate of 1/6 of the shares issued and every six months thereafter at the same rate until all the shares are fully released on the third anniversary of the closing date. We agreed to bear all expenses associated with registering these shares for resale and granted to Mr. Dahan certain piggyback rights with respect to future registration statements filed by us. The investor rights agreement contains customary terms and conditions related to registration procedures, trading suspensions and indemnification of the parties. On March 24, 2008, a registration statement on Form S-3 was declared effective for the resale of up to 2,333,333 shares where the contractual restrictions on resale lapsed on April 25, 2008. Mr. Dahan has not requested the filing of any additional registration statements.

Contingent Consideration Payments

As part of the consideration paid in connection with the merger and without regard to continued employment, Mr. Dahan is entitled to a certain percentage of the gross profit earned by us in any applicable fiscal year until October 2017. Mr. Dahan is entitled to the following: (i) 11.33 percent of the gross profit from $11,251,000 to $22,500,000; (ii) three percent of the gross profit from $22,501,000 to $31,500,000; (iii) two percent of the gross profit from $31,501,000 to $40,500,000; (iv) one percent of the gross profit above $40,501,000. The payments may be paid in advance on a monthly basis based upon estimates of gross profits after the assumption has been reached that the payments are likely to be paid. At the end of each quarter, any overpayments are offset against future payments and any significant underpayments are made. No payments are made if the gross profit is less than $11,250,000. "Gross Profit" is defined as net sales of the Joe's® brand less cost of goods sold.

Litigation

We are involved from time to time in routine legal matters incidental to our business. In the opinion of our management, resolution of such matters will not have a material effect on our financial position or results of operations.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Segment Reporting and Operations by Geographic Areas

Segment Reporting

The following table contains summarized financial information concerning our reportable segments:

	Year ended		
	2011	**2010**	**2009**
Net sales:			
Wholesale	$ 76,901	$ 85,141	$ 75,238
Retail	18,519	13,035	4,878
	$ 95,420	$ 98,176	$ 80,116
Gross Profit:			
Wholesale	$ 31,097	$ 38,324	$ 36,605
Retail	12,267	7,889	3,180
	$ 43,364	$ 46,213	$ 39,785
Operating (loss)income:			
Wholesale	$ 18,000	$ 23,887	$ 24,748
Retail	(728)	(42)	(668)
Corporate and other	(17,837)	(17,824)	(15,557)
	$ (565)	$ 6,021	$ 8,523
Capital expenditures:			
Wholesale	$ 302	$ 17	$ 17
Retail	1,656	3,275	844
Corporate and other	97	110	12
	$ 2,055	$ 3,402	$ 873
Total assets:			
Wholesale	$ 44,399	$ 45,594	$ 47,607
Retail	7,594	7,980	3,732
Corporate and other	28,169	27,895	28,285
	$ 80,162	$ 81,469	$ 79,624

Operations by Geographic Areas

Currently, we do not have any material reportable operations outside of the United States.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Related Party and Other Transactions

As of November 30, 2011 and November 30, 2010, our related party balance consisted of amounts due to and due from certain related parties, as further described below, as follows:

	November 30, 2011	November 30, 2010
Due from related parties		
Everblue LLC	$ 529	$
Kids Jeans LLC		13
Albert Dahan	83	25
Total due from related parties	$ 612	$ 38
Due to related parties		
Joe Dahan	$ 343	$ 333
Kids Jeans LLC	14	
Total due to related parties	$ 357	$ 333

Joe Dahan

As part of the consideration paid in connection with the merger, Mr. Dahan is entitled to a certain percentage of our gross profit in any applicable fiscal year until October 2017. See "Note 8 Commitments and Contingencies Contingent Consideration Payments" for a further discussion on the contingent consideration.

For fiscal 2011, 2010 and 2009, payments of $1,757,000, $1,785,000, and $1,672,000, respectively, were made to Mr. Dahan.

Albert Dahan

In April 2009, we entered into a commission-based sales agreement with Albert Dahan, brother of Joe Dahan, for the sale of our products into the off-price channels of distribution. Under the agreement, Mr. Albert Dahan is entitled to a commission for purchase orders entered into by us where he acts as a sales person. The agreement may be terminated at any time for any reason or no reason with or without notice. For fiscal 2011, 2010 and 2009, payments of $580,000, $719,000 and $413,000, respectively, were made to Mr. Albert Dahan under this arrangement.

Effective as of June 1, 2009, we entered into a license agreement for the license of the children's product line with Kids Jeans LLC, or Kids LLC, an entity in which Mr. Albert Dahan holds an interest and has voting control. Under the terms of the license, Kids LLC had an exclusive right to produce, distribute and sell children's products bearing the Joe's® brand on a worldwide basis, subject to certain limitations on the channels of distribution. In exchange for the license, Kids LLC paid us a royalty payment of 20 percent on the first $5,000,000 in net sales, or $1,000,000. In April 2011, we terminated the license agreement and in June 2011, we entered into a settlement agreement with Kids LLC. Pursuant to the terms of the settlement agreement, Kids LLC agreed to pay to us approximately $450,000 in exchange for Kids LLC's right to continue to sell children's apparel products until September 30, 2011 or December 31, 2011, depending on the product to be sold and customer to whom it will be sold. In exchange, the parties entered into mutual releases with respect to all claims related to the subject matter. In October 2011, we entered into a new agreement, or New Agreement,

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Related Party and Other Transactions (Continued)

similar to the previous one, with Ever Blue LLC, or Ever Blue, an entity which Albert Dahan is the sole member, for the continued sale of children's products. In exchange for the license, Ever Blue pays to us a royalty on net sales with certain guaranteed minimum sales for each term. In connection with the New Agreement, we provided initial funding to Ever Blue for inventory purchases. The amount outstanding at November 30, 2011 was $529,000 and is due on demand.

11. Supplemental Cash Flow Information

	Year ended (in thousands)		
	2011	2010	2009
Significant Non-cash transactions			
Write off of fully depreciated fixed assets	$ 671	$ 189	$
Additional cash flow information			
Cash paid during the year for interest	$ 506	$ 513	$ 430
Cash paid during the year for income taxes	$ 218	$ 2,716	$ 1,138

12. Employee Benefit Plans

On December 1, 2002, we established a tax qualified defined contribution 401(k) Profit Sharing Plan, or the Plan. All employees who have worked for us for 30 consecutive days may participate in the Plan and may contribute up to 100 percent, subject to certain limitations, of their salary to the plan. We may make company matched contributions on a discretionary basis. All employees who have worked 500 hours qualify for profit sharing in the event at the end of each year we decide to do so. Costs of the Plan charged to operations were $16,000, $6,000, and $6,000 for fiscal 2011, 2010 and 2009, respectively. In addition, we match our employees' contributions under the Plan in the lesser of the following amounts: (i) up to 2 percent of the employee's compensation, or (ii) $^{1}/_{3}$ of the employee's contribution up to 6 percent of the employee's salary. For fiscal 2011, 2010 and 2009, we contributed $117,000, $107,000, and $59,000, respectively, to employees under the match portion of the Plan.

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Quarterly Results of Operations (Unaudited)

The following is a summary of the quarterly results of operations for the years ended November 30, 2011 and November 30, 2010:

	Quarter ended (in thousands, except per share data)			
2011	**February 28**	**May 31**	**August 31**	**November 30**
Net sales	$ 21,180	$ 24,701	$ 24,151	$ 25,388
Gross profit	10,385	11,521	9,744	11,714
Income (loss) before taxes	398	1,556	(2,753)	(250)
Income tax expense (benefit)	208	805	(715)	18
Net (loss) income	$ 190	$ 751	$ (2,038)	$ (268)
Net (loss) income per share:				
Earnings (loss) per common share basic	$ 0.00	$ 0.01	$ (0.03)	$ (0.00)
Earnings (loss) per common share diluted	$ 0.00	$ 0.01	$ (0.03)	$ (0.00)

	Quarter ended (in thousands, except per share data)			
2010	**February 28**	**May 31**	**August 31**	**November 30**
Net sales	$ 23,184	$ 25,893	$ 25,534	$ 23,565
Gross profit	11,366	11,501	11,802	11,544
Income before taxes	1,328	1,026	1,396	1,807
Income tax expense	634	494	838	990
Net income	$ 694	$ 532	$ 558	$ 817
Net income per share:				
Earnings per common share basic	$ 0.01	$ 0.01	$ 0.01	$ 0.01
Earnings per common share diluted	$ 0.01	$ 0.01	$ 0.01	$ 0.01

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JOE'S JEANS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Quarterly Results of Operations (Unaudited) (Continued)

ITEM 16.2
Joe's Jeans Inc. and Subsidiaries

Schedule II
Valuation of Qualifying Accounts

	(in thousands)				
Description	**Balance at Beginning of Period**	**Additions Charged to Costs & Expenses**	**Charged to Other Accounts**	**Deductions(1)**	**Balance at End of Period**
Allowance for doubtful accounts:					
Year ended November 30, 2011	$ 449	37		(166)	$ 320
Year ended November 30, 2010	$ 501	28		(80)	$ 449
Year ended November 30, 2009	$ 540	277		(316)	$ 501
Allowance for customer credits:					
Year ended November 30, 2011	$ 3,407	12,156		(12,707)	$ 2,856
Year ended November 30, 2010	$ 2,936	12,838		(12,367)	$ 3,407
Year ended November 30, 2009	$ 2,207	10,142		(9,413)	$ 2,936
Allowances for inventories:					
Year ended November 30, 2011	$ 1,067	175		(128)	$ 1,114
Year ended November 30, 2010	$ 1,183	(116)		0	$ 1,067
Year ended November 30, 2009	$ 1,044	167		(28)	$ 1,183
Allowance for deferred taxes:					
Year ended November 30, 2011	$				$
Year ended November 30, 2010	$				$
Year ended November 30, 2009	$ 20,291			(20,291)	$

(1) Deductions represent the actual amount of write-off of an asset against a reserve previously recorded, or in the case of inventories, a deduction could represent the write-off upon disposition or a markdown of carrying value. In the case of deferred taxes, deductions result from changes in timing differences on a year-to-year basis.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

February 28, 2012

JOE'S JEANS INC.

By: /s/ MARC B. CROSSMAN

Marc B. Crossman
Chief Executive Officer (Principal Executive Officer) and President

By: /s/ HAMISH SANDHU

Hamish Sandhu
Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Marc Crossman, his attorney-in-fact, each with the power of substitution for him or any and all capacities, to sign any amendments to this Annual Report on Form 10-K and to file the same with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each said attorney-in-fact, or his or her substitutes, may do or cause to be done by virtue hereof. Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ MARC B. CROSSMAN Marc B. Crossman	Chief Executive Officer (Principal Executive Officer), President and Director	February 28, 2012
/s/ HAMISH SANDHU Hamish Sandhu	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 28, 2012
/s/ SAMUEL J. FURROW Samuel J. Furrow	Chairman of the Board of Directors	February 28, 2012
/s/ JOSEPH M. DAHAN Joseph M. Dahan	Director	February 28, 2012
/s/ KELLY HOFFMAN Kelly Hoffman	Director	February 28, 2012

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Signature	Capacity	Date
/s/ SUHAIL R. RIZVI Suhail R. Rizvi	Director	February 28, 2012
/s/ THOMAS O'RIORDAN Thomas O'Riordan	Director	February 28, 2012
/s/ KENT SAVAGE Kent Savage	Director	February 28, 2012