

TALON INTERNATIONAL, INC.  
Form 10-Q  
November 12, 2013

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

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**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934.

For the quarterly period ended September 30, 2013.

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934.

Commission file number 1-13669

**TALON INTERNATIONAL, INC.**

(Exact Name of Issuer as Specified in its Charter)

<b>Delaware</b>	<b>95-4654481</b>
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

**21900 Burbank Boulevard, Suite 270**

**Woodland Hills, California 91367**

(Address of Principal Executive Offices)

**(818) 444-4100**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

At November 8, 2013, the issuer had 91,337,217 shares of Common Stock, \$.001 par value, issued and outstanding.



**TALON INTERNATIONAL, INC.**

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**TALON INTERNATIONAL, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2013 (Unaudited)</b>	<b>December 31, 2012</b>
Assets		
Current assets:		
Cash and cash equivalents	\$3,974,977	\$8,927,333
Accounts receivable, net	3,525,802	3,635,136
Inventories, net	971,598	730,503
Prepaid expenses and other current assets	561,143	456,460
Total current assets	9,033,520	13,749,432
Property and equipment, net	719,580	763,770
Intangible assets, net	4,270,381	4,279,943
Other assets	215,753	182,671
Total assets	\$14,239,234	\$18,975,816
Liabilities, Preferred Stock and Stockholders' Equity (Deficit)		
Current liabilities:		
Accounts payable	\$7,426,172	\$7,866,662
Accrued expenses	2,916,930	2,023,535
Note payable	5,800,000	-
Current portion of capital lease obligations	657	3,247
Total current liabilities	16,143,759	9,893,444
Deferred income taxes	1,053,860	945,543
Other liabilities	27,920	186,051
Total liabilities	17,225,539	11,025,038
Commitments and contingencies (Note 12)		
Series B Convertible Preferred Stock, \$0.001 par value; no shares authorized, issued or outstanding at September 30, 2013; 407,160 shares outstanding at December 31, 2012	-	23,979,216
Stockholders' Equity (Deficit):		
Common Stock, \$0.001 par value, 100,000,000 shares authorized; 91,913,217 and 23,400,808 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	91,913	23,401

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Additional paid-in capital	64,113,369	58,458,731
Accumulated deficit	(67,310,141)	(74,578,052)
Accumulated other comprehensive income	118,554	67,482
Total stockholders' equity (deficit)	(2,986,305 )	(16,028,438)
Total liabilities, preferred stock and stockholders' equity (deficit)	\$14,239,234	\$18,975,816

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net sales	\$ 13,728,037	\$ 11,288,717	\$ 40,508,751	\$ 33,214,516
Cost of goods sold	9,143,655	7,637,845	27,196,451	22,434,159
Gross profit	4,584,382	3,650,872	13,312,300	10,780,357
Sales and marketing expenses	1,568,257	1,205,552	4,364,742	3,469,024
General and administrative expenses	2,077,100	2,070,088	6,211,057	6,435,569
Total operating expenses	3,645,357	3,275,640	10,575,799	9,904,593
Income from operations	939,025	375,232	2,736,501	875,764
Interest expense, net	10,641	5,950	11,216	47,710
Income before provision for income taxes	928,384	369,282	2,725,285	828,054
Provision for income taxes, net	228,328	182,417	482,161	175,685
<b>Net income</b>	<b>\$ 700,056</b>	<b>\$ 186,865</b>	<b>\$ 2,243,124</b>	<b>\$ 652,369</b>
Series B Preferred Stock liquidation preference increase	(116,029 )	(857,877 )	(1,914,470 )	(2,408,257 )
Series B Preferred Stock redemption discount, net	6,939,257	-	6,939,257	-
Net Income (loss) applicable to Common Shareholders	\$ 7,523,284	\$ (671,012 )	\$ 7,267,911	\$ (1,755,888 )
<b>Per share amounts:</b>				
Net income per share	\$0.01	\$0.01	\$0.05	\$0.03
Net income per share (applicable to) redeemed from Preferred Stock	0.08	(0.04 )	0.11	(0.11 )
Basic net income (loss) per share applicable to Common Shareholders	\$0.09	\$(0.03 )	\$0.16	\$(0.08 )
Diluted net income (loss) per share applicable to Common Shareholders	\$0.09	\$(0.03 )	\$0.15	\$(0.08 )
Weighted average number of common shares outstanding – Basic	82,946,352	22,911,678	44,297,109	22,141,684
Weighted average number of common shares outstanding – Diluted	86,379,163	22,911,678	47,870,968	22,141,684
<b>Net income</b>	<b>\$ 700,056</b>	<b>\$ 186,865</b>	<b>\$ 2,243,124</b>	<b>\$ 652,369</b>
Other comprehensive income (loss) from foreign currency translation	21,221	(24,414 )	51,072	(10,728 )
<b>Total comprehensive income</b>	<b>\$ 721,277</b>	<b>\$ 162,451</b>	<b>\$ 2,294,196</b>	<b>\$ 641,641</b>



See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
<i>Cash flows from operating activities:</i>		
Net income	\$2,243,124	\$652,369
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	370,751	401,141
(Gain) from disposal of equipment	(232)	(67,576)
Amortization of deferred financing cost	-	17,500
Stock based compensation	385,821	387,973
Deferred income taxes, net	108,317	215,402
Bad debt expense, net	18,809	5,108
Inventory valuation provisions, net	45,952	39,412
Changes in operating assets and liabilities:		
Accounts receivable	108,558	(604,654)
Inventories	(286,956)	362,695
Prepaid expenses and other current assets	(99,652)	(247,043)
Other assets	(32,084)	9,508
Accounts payable and accrued expenses	399,749	771,156
Other liabilities	(158,131)	(201,058)
Net cash provided by operating activities	3,104,026	1,741,933
<i>Cash flows from investing activities:</i>		
Acquisitions of intangibles	-	(174,535)
Proceeds from sale of equipment	1,832	168
Acquisitions of property and equipment	(316,215)	(173,464)
Net cash (used in) investing activities	(314,383)	(347,831)
<i>Cash flows from financing activities:</i>		
Common stock issuance through Private Placement	5,500,000	-
Private Placement issuance costs	(162,671)	-
Series B Preferred Stock redemption costs	(154,429)	-
Note payable issuance	5,800,000	-

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Series B Preferred Stock redemption	(18,800,000)	-
Payment of notes payable to related parties	-	(240,957 )
Payment of other notes payable	-	(66,675 )
Payment of capital leases	(2,590 )	(3,667 )
Net cash (used in) financing activities	(7,819,690 )	(311,299 )
Net effect of foreign currency exchange translation on cash	77,691	(7,098 )
Net increase (reduction) in cash and cash equivalents	(4,952,356 )	1,075,705
Cash and cash equivalents at beginning of period	8,927,333	5,749,341
Cash and cash equivalents at end of period	\$3,974,977	\$6,825,046

See accompanying notes to consolidated financial statements.

**TALON INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

Supplemental disclosures of cash flow information:

	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
Cash received (paid) during the period for:		
Interest paid	\$(1,602 )	\$(2,545 )
Interest received	\$3,256	\$3,041
Income tax paid, net (principally foreign)	\$(106,015 )	\$(184,981 )
Non-cash financing activities:		
Series B preferred stock liquidation preference increase	\$(1,914,470)	\$(2,408,257)
Series B preferred stock redemption discount	\$7,093,686	\$-
RSU's settlement in common stock	\$7,401	\$2,400
Interest accrued on notes payable	\$-	\$1,540
Effect of foreign currency translation on net assets	\$51,072	\$(10,728 )
Non-cash investing activities:		
Equipment exchanged for manufacturing services	\$-	\$67,632
Capital lease terminations	\$-	\$9,802

See accompanying notes to consolidated financial statements.

**TALON INTERNATIONAL, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**Note 1. Presentation of Interim Information**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited consolidated financial statements reflect all adjustments that, in the opinion of the management of Talon International, Inc. and its consolidated subsidiaries (collectively, the “Company”), are considered necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations for such periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in the Company’s Form 10-K for the year ended December 31, 2012. The balance sheet as of December 31, 2012 has been derived from the audited financial statements as of that date but omits certain information and footnotes required for complete financial statements.

**Note 2. Summary of Significant Accounting Policies**

A complete description of the Company’s Significant Accounting Policies is included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012, and should be read in conjunction with these unaudited consolidated financial statements. The Significant Accounting Policies noted below are only those policies that have changed materially or have supplemental information included for the periods presented here.

*Allowance for Accounts Receivable Doubtful Accounts*

The Company is required to make judgments as to the collectability of accounts receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts and that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables to their net realizable value. The Company records these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on our historical experience, for issues not yet identified. Bad debt expense (recovery), net on accounts receivable for the three and nine months ended September 30, 2013 was \$(2,050) and \$18,809, respectively. Bad debt expense (recovery), net on accounts receivable for the three and nine months ended September 30, 2012 was \$(8,265) and \$5,108, respectively

#### *Fair Value Measurements*

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the fair value guidance establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

Level 2 - Includes other inputs that are directly or indirectly observable in the marketplace.

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

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

The Company's financial instruments include cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses, note payable and other liabilities. The book value of the financial instruments is representative of their fair values. In accordance with this guidance, the Company measures its cash equivalents at fair value. The Company's cash equivalents are classified within Level 1. Cash equivalents are valued primarily using quoted market prices utilizing market observable inputs. At September 30, 2013 and December 31, 2012, cash equivalents consisted of money market funds measured at fair value on a recurring basis; fair value of the Company's money market funds was approximately \$955,000 and \$2,230,000, respectively.

The Company adopted the Financial Accounting Standards Board ("FASB") staff position that delayed the guidance on fair value measurements for non-financial assets and non-financial liabilities. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

*Intangible Assets*

Intangible assets consist of the *Talon* trade name acquired in a purchase business combination, patents, licenses, intellectual property rights and technology. Intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually in

accordance with the provisions of FASB Accounting Standards Codification (“ASC”) 350, *“Intangibles - Goodwill and Other”*. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with the provisions of ASC 360, *“Property, Plant and Equipment”*. Costs incurred to renew or extend the term of recognized intangible assets are capitalized and amortized over the useful life of the asset.

In July 2012, the FASB issued Accounting Standards Update (“ASU”) 2012-02, *“Intangibles – Goodwill and Other - Testing Indefinite-lived Intangible Assets for Impairment.”* The updated guidance gives companies the option to first perform a qualitative assessment to determine whether it is more likely than not, defined as a likelihood of more than 50%, that an indefinite-lived intangible asset is impaired. If it is determined that it is more likely than not that an impairment exists, then the company is required to estimate the fair value of the indefinite-lived intangible assets and perform a quantitative impairment test in accordance with ASU 350-30. The updated guidance was effective for annual and interim indefinite lived intangibles asset impairment tests performed for fiscal years, and interim periods within those years, beginning after September 15, 2012. Early adoption was permitted as of a date before July 27, 2012. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements. We completed the required assessment at September 30, 2013 and December 31, 2012, and noted no impairment. Consequently, no impairment charges were recorded.



**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

On April 2, 2002, the Company entered into an Exclusive License and Intellectual Property Rights Agreement (the "License Agreement") with Pro-Fit Holdings Limited ("Pro-Fit"). The License Agreement granted the Company the exclusive rights to sell or sublicense waistbands manufactured under patented technology developed by Pro-Fit for garments manufactured anywhere in the world for sale in the United States market and to all United States brands. The License Agreement had an indefinite term that extended for the duration of the trade secrets and patented technology licensed under the License Agreement. The Company recorded an intangible asset of \$612,500, which has been fully amortized.

During the quarter ended March 31, 2012 the Company completed the acquisition from Pro-Fit and related parties of all U.S. patents, and applications, rights and technology associated with the stretch waistband technology that was formerly exclusively licensed under the License Agreement, and the License Agreement was terminated. During the quarter ended September 30, 2012 the Company also acquired other intellectual property related to accessory components used with a variety of apparel products. The total purchase price and related fees for all intangibles acquired in 2012 totaled \$178,722, and is amortized based on the estimated useful lives between 10 and 17 years. Amortization expense for intangible assets was \$3,271 and \$9,562 for the three and nine months ended September 30, 2013, respectively. Amortization expense for intangible assets was \$3,249 and \$6,140, respectively for the three and nine months ended September 30, 2012.

Intangible assets as of September 30, 2013 and December 31, 2012 are as follows:

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Tradename	\$4,110,751	\$4,110,751
Intellectual property rights and exclusive license	178,722	178,722
Accumulated amortization	(19,092 )	(9,530 )
Intellectual property rights, net	159,630	169,192
Intangible assets, net	\$4,270,381	\$4,279,943

*Convertible Preferred Stock*

On July 12, 2013 the Company entered into a Securities Redemption Agreement (the “Redemption Agreement”) with CVC California, LLC (“CVC”). Pursuant to the Redemption Agreement, the Company repurchased from CVC all of the 407,160 outstanding shares of the Company’s Series B Convertible Preferred Stock (the “Series B Preferred Stock”) for an aggregate purchase price of \$18,800,000, which purchase price was paid by delivery of \$13,000,000 in cash and the issuance to CVC of a promissory note in the principal amount of \$5,800,000 (the “Promissory Note”). As of the date of the transaction, the total value of the Series B Convertible Preferred Stock was \$25,893,686, and a redemption discount (net of redemption costs of \$154,429) of \$6,939,257 was recorded to accumulated deficit on the consolidated balance sheets, and reflected in the earnings per share calculation of net income available to common shareholders.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

The Company reported its conditionally redeemable convertible preferred shares as temporary equity in the mezzanine section of the consolidated balance sheets, in accordance with the guidance enumerated in FASB ASC No. 480-10 “*Distinguishing Liabilities from Equity*”, FASB ASC No. 210 “*Classification and Measurement of Redeemable Securities*” and Rule 5-02.28 of Regulation S-X, when determining the classification and measurement of preferred stock.

The Company reported the conversion option of its convertible preferred shares in accordance with FASB ASC No. 470-20, “*Debt with Conversion and Other Options*”, Accounting for Convertible Securities with Beneficial Conversion Features (“BCF”) or Contingently Adjustable Conversion Ratios. A convertible financial instrument includes a BCF when the fair market value of the preferred stock is lower than the value of common stock when the preferred stock converts to common stock at the issuance date. The BCF shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the feature to additional paid-in capital.

The convertible preferred shares, which were redeemable preferred securities, were reported at their current liquidation preference amount. Redeemable securities initially are recorded at their fair value minus the BCF and minus preferred stock issuance costs, and then are subsequently adjusted for changes in the preferred stock value in accordance with the following guidelines:

When an equity instrument is not currently redeemable but it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), then changes in the redemption value are recognized as they occur, and the carrying amount of the instrument is adjusted to equal the current redemption value. An increase in the carrying amount of the instrument reduces income available to common shareholders in the calculation of earnings per share.

When the liquidation preference increases on preferred shares it is added to the preferred stock carrying amount, and reduces income available to common shareholders in the calculation of earnings per share.

*Classification of Expenses*

*Costs of Goods Sold* – Cost of goods sold primarily includes expenses related to inventory purchases, customs, duty, freight, overhead expenses and reserves for obsolete inventory. Overhead expenses primarily consist of warehouse and operations salaries, and other warehouse expense.

*Sales and Marketing Expenses* – Sales and marketing expenses primarily include sales salaries and commissions, travel and entertainment, marketing, advertising, royalty expense, and other sales related costs. Marketing and advertising efforts are expensed as incurred.

*General and Administrative Expenses* – General and administrative expenses primarily include administrative salaries, employee benefits, professional service fees, facility expenses, information technology costs, investor relations, travel and entertainment, depreciation and amortization, bad debts and other general corporate expenses.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

*Interest Expense, net* – Interest expense reflects the cost of borrowing. Interest expense for the three and nine months ended September 30, 2013 totaled \$11,800 and \$14,472 respectively. Interest expense for the three and nine months ended September 30, 2012 totaled \$7,288 and \$50,751, respectively. Interest income consists of earnings from cash held in interest bearing accounts. For the three and nine months ended September 30, 2013 the Company recorded interest income of \$1,159 and \$3,256, respectively. For the three and nine months ended September 30, 2012 the Company recorded interest income of \$1,338 and \$3,041, respectively.

*Foreign Currency Translation*

The Company has operations and holds assets in various foreign countries. The local currency is the functional currency for the Company's subsidiaries in China and India. Assets and liabilities are translated at end-of-period exchange rates while revenues and expenses are translated at the average exchange rates in effect during the period. Equity is translated at historical rates and the resulting cumulative translation adjustments are included as a component of accumulated other comprehensive income until the translation adjustments are realized. Included in accumulated other comprehensive income were a cumulative foreign currency translation gain of \$118,554 and \$67,482 at September 30, 2013 and December 31, 2012, respectively.

*Comprehensive Income*

Comprehensive income consists of net income and unrealized income (loss) on foreign currency translation adjustments. The foreign currency translation adjustment represents the net currency translation gains and losses related to our China and India subsidiaries, which have not been reflected in the net income for the periods presented.

In the first quarter of 2012 we adopted FASB ASU 2011-05, "*Presentation of Comprehensive Income*" ("ASU 2011-05") and ASU 2011-12, "*Comprehensive Income (Topic 220)*", which amended ASC Topic 220, "*Comprehensive Income*", and was effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company chose the option provided by ASU 2011-05 to present the total of comprehensive income (loss), the components of net income (loss) and the components of other comprehensive income (loss) in a single continuous statement. Adoption of the guidance did not have any impact on our results of operations or financial condition.

*Use of Estimates*

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. The accounting estimates that require the Company's most significant, difficult and subjective judgments include the valuation allowance for accounts receivable and inventory, and the assessment of recoverability of long-lived assets and intangible assets, stock-based compensation and the recognition and measurement of current and deferred income taxes (including the measurement of uncertain tax positions). Actual results could differ materially from the Company's estimates.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)****Note 3. New Accounting Pronouncements**

In July 2013, the FASB issued ASU 2013-11, "*Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*" ("ASU 2013-11"), which sets forth explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This guidance is effective for fiscal years, and interim periods beginning after December 15, 2013, with early adoption permitted. The Company adopted ASU 2013-011 as of September 30, 2013 with no impact on the consolidated financial statements.

**Note 4. Net Income (Loss) Per Share**

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

	<b>Net income (loss)</b>	<b>Shares</b>	<b>Per Share Amount</b>
<b>Three Months ended September 30, 2013:</b>			
Basic net income per share:			
Net income	\$ 700,056	82,946,352	\$ 0.01
Series B Preferred Stock liquidation preference increase prior to redemption	(116,029 )		0.00
Series B Preferred Stock Redemption discount, net	6,939,257		0.08
Net income applicable to Common Shareholders	7,523,284	82,946,352	0.09

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Effect of Dilutive Securities - Options, Preferred Stock and RSUs	-	3,432,811	-
Diluted net income applicable to Common Shareholders	\$ 7,523,284	86,379,163	\$ 0.09

**Three Months ended September 30, 2012:**

Basic net income per share:

Net income	\$ 186,865	22,911,678	\$ 0.01
Series B Preferred Stock liquidation preference increase	(857,877 )		(0.04 )
Net income (loss) applicable to Common Shareholders	(671,012 )	22,911,678	(0.03 )
Effect of Dilutive Securities - Options, Preferred Stock and RSUs	-	-	-
Diluted net income (loss) applicable to Common Shareholders	\$ (671,012 )	22,911,678	\$ (0.03 )



## TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

	Net income (loss)	Shares	Per Share Amount
<b>Nine Months ended September 30, 2013:</b>			
Basic net income per share:			
Net income	\$2,243,124	44,297,109	\$ 0.05
Series B Preferred Stock liquidation preference increase prior to redemption	(1,914,470)		(0.04 )
Series B Preferred Stock redemption discount, net	6,939,257		0.15
Net income applicable to Common Shareholders	7,267,911	44,297,109	0.16
Effect of Dilutive Securities - Options, Preferred Stock and RSUs	-	3,573,859	-
Diluted net income applicable to Common Shareholders	\$7,267,911	47,870,968	\$ 0.15
<b>Nine Months ended September 30, 2012:</b>			
Basic net income per share:			
Net income	\$652,369	22,141,684	\$ 0.03
Series B Preferred Stock liquidation preference increase	(2,408,257)		(0.11 )
Net Income (loss) applicable to Common Shareholders	(1,755,888)	22,141,684	(0.08 )
Effect of Dilutive Securities - Options, Preferred Stock and RSUs	-	-	-
Diluted net income (loss) applicable to Common Shareholders	\$(1,755,888)	22,141,684	\$ (0.08 )

For the three months ended September 30, 2013, options to purchase 5,595,000 shares of common stock exercisable between \$0.04 and \$0.20 per share and RSU's to settle for 1,155,700 common shares were included in the computation of diluted net income per share. Options to purchase 639,600 shares of common stock exercisable between \$0.28 and \$5.23 per share were outstanding but were not included in the computation of diluted net income per share applicable to common shareholders because they would have an antidilutive effect on the net income per share.

For the nine months ended September 30, 2013, options to purchase 2,355,000 shares of common stock exercisable between \$0.04 and \$0.11 per share and RSU's to settle for 1,155,700 common shares were included in the computation of diluted net income per share. Options to purchase 3,879,600 shares of common stock exercisable between \$0.08 and \$5.23 per share were outstanding but were not included in the computation of diluted net income per share applicable to common shareholders because they would have an antidilutive effect on the net income per share.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

On July 12, 2013 the Company entered into the Redemption Agreement with CVC. Pursuant to the Redemption Agreement, the Company repurchased from CVC all of the 407,160 outstanding shares of Series B Preferred Stock for an aggregate purchase price of \$18,800,000, which purchase price was paid to CVC by delivery of \$13,000,000 in cash and an unsecured Promissory Note in the principal amount of \$5,800,000. In order to provide additional funds to complete the redemption of the Series B Preferred Stock, the Company raised \$5,500,000 of new equity capital through the sale, in a private placement transaction, of 61,111,109 shares of common stock at a price of \$0.09 per share. Additionally, on July 12, 2013, 4,745,600 shares of common stock were issued to reporting persons in settlement of previously vested restricted stock units pursuant to an existing deferral election. For the repurchase of Series B Convertible Preferred Stock, a redemption discount (net of redemption costs) of \$6,939,257 was recorded to accumulated deficit on the consolidated balance sheets, and in the earnings per share calculation of net income available to common shareholders.

For the three and nine months ended September 30, 2012, options to purchase 6,372,100 shares of common stock exercisable between \$0.04 and \$5.23 per share, RSU's to settle for 8,557,000 common shares and Series B Preferred Stock to be converted into 40,716,000 shares of common stock were outstanding, but were not included in the computation of diluted net income (loss) per share because they would have an antidilutive effect on the net income (loss) per share.

**Note 5. Accounts Receivable**

Accounts receivable are included on the consolidated balance sheets net of the allowance for doubtful accounts. The allowance for doubtful accounts at September 30, 2013 and December 31, 2012 was \$20,899 and \$1,093, respectively.

**Note 6. Inventories**

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

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

Inventories consist of the following:

	<b>September 30,</b>	<b>December 31,</b>
	2013	2012
Finished goods	\$ 1,216,118	\$ 991,635
Less reserves	(244,520 )	(261,132 )
Total inventories	\$ 971,598	\$ 730,503

**Note 7. Note Payable**

On July 12, 2013 the Company entered into the Redemption Agreement with CVC pursuant to which the Company repurchased all of the 407,160 outstanding shares of Series B Preferred Stock for an aggregate purchase price of \$18,800,000. The purchase price was paid to CVC by delivery of \$13,000,000 in cash and an unsecured Promissory Note in the principal amount of \$5,800,000.

The Promissory Note accrues interest in the amount of 1% per annum, is due and payable in full on January 12, 2014, and includes discounts for early repayments that decrease over time. The Promissory Note further requires mandatory prepayments equal to a specified portion of the proceeds received by the Company with respect to future secured debt financing transactions, as well as customary default provisions.

Interest expense related to the note payable for the three and nine months ended September 30, 2013 was \$12,871, and was included in accrued interest, which is due and payable in full on January 12, 2014.

**Note 8. Debt Facility**

The Company originally entered into a Revolving Credit and Term Loan Agreement (the "Loan Agreement") on June 27, 2007 with Bluefin Capital, LLC ("Bluefin"). Bluefin subsequently assigned its rights and obligations under the Loan Agreement to an affiliate, CVC. On July 30, 2010, the Company entered into a Recapitalization Agreement (the "Recapitalization Agreement") with CVC in which the Company issued to CVC shares of the Company's Series B Preferred Stock in payment of all of the outstanding obligations owed by the Company to CVC under the Loan Agreement, (see Note 9). All of the outstanding obligations owed to CVC under the Loan Agreement that became due and payable on July 30, 2010, in the amount of \$16,706,685, were converted into Series B Preferred Stock pursuant to the Recapitalization Agreement. These obligations consisted of outstanding borrowings and accrued interest of \$11,548,098 under term notes, and \$5,158,587 under a revolving credit note.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

In connection with the Recapitalization Agreement, the Loan Agreement (now fully paid and expired) was amended to extend the maturity date from July 30, 2010 until July 31, 2012, reduce the maximum borrowings available under the Revolver to \$3,000,000, and amend various additional terms and conditions of the Loan Agreement. The Company paid CVC a non-refundable fee in the amount of \$60,000 in consideration of CVC entering into the July 2010 amendment and making this facility available and paid a \$50,000 commitment fee during the third quarter of 2011 to ensure the availability of the revolver through July 31, 2012. Upon execution of the amendment, CVC waived all prior events of default under the Loan Agreement. Borrowings under the Loan Agreement were secured by all of the Company's assets.

On July 31, 2012, with no borrowings outstanding, the Loan Agreement expired along with all performance covenants, obligations and liens against any assets of the Company.

Interest expense related to the debt facility for the three months ended September 30, 2012 was \$6,667, and composed of amortization of deferred financing costs of \$2,500 and commitment fee expense of \$4,167. Interest expense related to the debt facility for the nine months ended September 30, 2012 was \$46,667, and composed of amortization of deferred financing costs of \$17,500 and commitment fee expense of \$29,167.

**Note 9. Series B Convertible Preferred Stock and Stockholders' Equity (Deficit)**

**Series B Convertible Preferred Stock Redemption and Private Placement of Common Stock**

On July 12, 2013 the Company entered into the Redemption Agreement with CVC and repurchased from CVC all of the 407,160 previously outstanding shares of Series B Preferred Stock (described below) for an aggregate purchase price of \$18,800,000, which purchase price was paid by delivery to CVC of \$13,000,000 in cash an unsecured

Promissory Note in the principal amount of \$5,800,000. Pursuant to the Redemption Agreement, the Stockholder's Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors of the Company, and Larry Dyne, President of the Company was terminated. In order to provide additional funds to complete the redemption of the Series B Preferred Stock, the Company raised \$5,500,000 of new equity capital through the sale, in a private placement transaction, of 61,111,109 shares of common stock at a price of \$0.09 per share. The closing of the private placement was expressly conditioned upon the contemporaneous closing of the transactions under the Redemption Agreement.

The redemption of the Series B Preferred Stock eliminated the Company's preferred stock liquidation preference obligation of \$25,893,686, which had entitled the preferred shareholders to payment of the preference amount before payment to the common stockholders. The liquidation preference was scheduled to increase to \$40,704,105 in 2016, the time which the preferred shares would have become mandatorily redeemable. The Company now has only common shares outstanding.

In connection with the redemption in full of the Series B Preferred Stock, CVC representative on the Company Board of Directors, Mark Hughes resigned from Board of Directors effective July 12, 2013.

As a result of the redemption, on July 12, 2013 a total of 4,745,600 shares of common stock were issued to the Company's executive management team upon settlement of previously vested RSU's pursuant to the 2010 deferral elections.



**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

The following table summarizes Series B Preferred Stock activity for the three and nine months ended September 30, 2013:

Series B Preferred Stock as of December 31, 2012	\$23,979,216
Series B Preferred Stock liquidation preference increase for the six months ended June 30, 2013	1,798,441
Series B Preferred Stock as of June 30, 2013	25,777,657
Series B Preferred Stock liquidation preference increase for July 1-July 12, 2013	116,029
Series B Preferred Stock as of July 12, 2013 per original redemption value	25,893,686
Series B Preferred Stock redemption discount	(7,093,686 )
Series B Preferred Stock before the Redemption	18,800,000
Series B Preferred Stock Redemption on July 12, 2013	(18,800,000)
Series B Preferred Stock as of September 30, 2013	\$-

Following the redemption of the Series B Preferred Stock, the Company amended the Corporation's Certificate of Incorporation to eliminate all of the Series A Preferred Stock (none of which were outstanding) and to eliminate all of the Series B Convertible Preferred Stock, all of which had been redeemed.

**Series B Convertible Preferred Stock Original Issuance**

On July 30, 2010, the Company entered into the Recapitalization Agreement with CVC, pursuant to which the Company issued to CVC an aggregate of 407,160 shares of a newly created series of the Company's preferred stock,

designated Series B Convertible Preferred Stock, \$0.001 par value per share in payment of an aggregate of \$16,706,685 owed by the Company to CVC under the Loan Agreement. Certain rights, preferences, privileges and restrictions previously provided to the Series B Preferred Stock are summarized below.

The Series B Preferred Stock had the following rights, preferences, privileges and restrictions:

The Series B Preferred Stock ranked senior to the common stock and to any other preferred stock unless such preferred stock was created and issued on a senior or pari passu basis in accordance with the Company's certificate of incorporation.

Each share of Series B Preferred Stock was convertible into 100 shares of the Company's common stock (subject to adjustment for stock splits, reverse stock split, etc.) at any time and from time to time at each holder's option, unless the Series B Preferred Stock was exchanged for its Liquidation Preference as noted below.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

Upon the liquidation, dissolution or winding up of the Company, each share of Series B Preferred Stock was entitled to receive upon the surrender and cancellation of such shares (and prior to any distribution to holders of other equity securities), an amount equal to \$41.033 per share plus all accrued dividends (the "Liquidation Preference"). A merger, consolidation, share exchange or other reorganization resulting in a change in control of the Company, or any sale of all or substantially all of the Company's assets, would be deemed a liquidation and winding up for purposes of the Company's obligation to pay the Liquidation Preference.

The Series B Preferred Stock Liquidation Preference increased at the rate of 16% per annum, compounded annually, in the form of a dividend accrual on the Liquidation Preference. The dividend however was only payable in connection with the payment of the Liquidation Preference upon the liquidation, dissolution or winding up of the Company, and in each case in exchange for the surrender of the Series B Preferred Stock. No portion of the Liquidation Preference or the associated accrued dividends were convertible into common stock, nor was any portion of the Liquidation Preference or the accrued dividends payable on shares of Series B Preferred Stock in the event of or following the conversion of such shares into common stock.

The Company had the right, at any time upon not less than thirty (30) days' prior written notice to the holders of Series B Preferred Stock, to redeem the Series B Preferred Stock in whole (but not in part) for a price equal to the then-applicable Liquidation Preference. The holders of Series B Preferred Stock had the option, exercisable at any time and from time to time commencing on July 31, 2016, to require the Company to redeem any or all of the Series B Preferred Stock held by such holders, at the then-applicable Liquidation Preference amount.

The Series B Preferred Stock voted with the common stock as a single class on all matters submitted or required to be submitted to a vote of the Company's stockholders, with each share of Series B Preferred Stock having a number of votes equal to the number of shares of common stock that may be acquired upon conversion thereof as of the applicable date of determination. Additionally, the Series B Preferred Stock had the right to vote as a separate class with respect to certain matters affecting the Series B Preferred Stock, including but not limited to (a) the creation or issuance of any other class or series of preferred stock, (b) any amendments with respect to the rights, powers, preferences and limitations of the Series B Preferred Stock, (c) paying dividends or distributions in respect of or redeem the Company's common stock or any other junior securities; and (d) certain affiliate transactions. Any such vote required the affirmative vote or consent of a majority of the outstanding shares of Series B Preferred Stock.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

As long as the outstanding Series B Preferred Stock represented 35% or more of the voting shares of the Company, on an as-converted to common stock basis, then (a) our Board of Directors consisted of not more than seven members, (b) the holders of Series B Preferred Stock had the right to elect three directors if the Board had five or fewer total directors, and four directors if the Board had six or seven directors (the directors elected by the Series B Preferred Stock were referred to as the "Series B Directors"), and (c) those members serving on the Board who were not elected by holders of the Series B Preferred Stock had the right to designate all remaining directors. At least two of the Series B Directors had to be, and remain at all times while serving as a director, an independent director that qualified for service on the audit committee of a corporation with securities listed on the Nasdaq Stock Market as provided in Nasdaq Marketplace Rule 5605(c)(2) (or any successor thereto). Once the outstanding shares of Series B Preferred Stock represent less than 35% of the voting shares on an as-converted to common stock basis, then the entire Board will thereafter be elected by all stockholders having voting rights, voting as a single class.

The conversion of the term notes, revolver and related interest and fees into the Series B Preferred Stock (fair value of \$17,277,600 as of July 30, 2010) was considered to be debt extinguishment according to the FASB ASC No.405 "*Liabilities*" and FASB ASC No. 470-50 "*Debt, Modifications and Extinguishments*" ("ASC 470-50"). Per ASC 470-50 a loss on extinguishment of debt of \$570,915 was recorded on July 30, 2010 and is included in the Consolidated Statement of Operations for the year ended December 31, 2010. The loss on extinguishment is equal to the difference between fair value of the preferred stock and the fair value of the debt extinguished at the transaction date. The fair value of the Series B Preferred Stock on the issuance date was determined by the Company and independent valuation specialists using the option pricing valuation model.

The Company applied the guidance enumerated in FASB ASC No. 480 "*Distinguishing Liabilities from Equity*", FASB ASC No. 210 "*Classification and Measurement of Redeemable Securities*" and Rule 5-02.28 of Regulation S-X, when determining the classification and measurement of preferred stock. The Company classifies conditionally redeemable convertible preferred shares, which includes preferred shares subject to redemption upon the occurrence of uncertain events not solely within the control of the Company, as temporary equity in the mezzanine section of the consolidated balance sheet. The Series B Preferred Stock was redeemable at the option of the holders after the sixth anniversary of issuance, which was not within the control of the Company.

The Company determined that there were no embedded features that would require separate reporting as derivative instruments. Therefore, the Company evaluated the conversion option of the convertible preferred shares under FASB ASC No. 470-20, "*Debt with Conversion and Other Options*", Accounting for Convertible Securities with Beneficial Conversion Features ("BCF") or Contingently Adjustable Conversion Ratios. A convertible financial instrument includes a BCF if the fair value of the instrument is lower than the fair value of shares of the common stock it is convertible into on the issuance date. The BCF shall be recognized separately at issuance by allocating a portion of

the proceeds equal to the intrinsic value of the conversion feature to additional paid-in capital. The Company recorded a BCF value of \$1,283,343 in connection with the issuance of the Series B Preferred Stock on July 30, 2010.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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The Series B Preferred Stock was initially recorded at the fair value of \$17,277,600 as of July 30, 2010, reduced by the BCF (\$1,283,343) as stated above and stock issuance costs (\$190,744), for a net value of \$15,803,513 as of July 30, 2010. The value of the Series B Preferred Stock was adjusted as follows as a consequence of its redemption features and the following approach was implemented by the Company:

The Series B Preferred Stock was not redeemable by the holders, but it was probable that the preferred stock could become redeemable due to the redemption option available to the preferred stock holders on July 30, 2016. Changes in the redemption value were recognized immediately as they occurred, and the carrying amount of the instrument was adjusted to equal the redemption value at the end of each reporting period. This method viewed the end of the reporting period as if it were also the redemption date for the Series B Preferred Stock. Accordingly, the adjustment of \$903,172 to record the preferred stock at its redemption value ("Original issue discount") was charged against the preferred stock carrying value and retained earnings during the year ended December 31, 2010. In addition, the resulting increase in the carrying amount of the Series B Preferred Stock reduced the income applicable to common shareholders reported in the calculation of earnings per share.

The annual 16% liquidation preference increase on outstanding preferred shares was accrued each reporting period as an addition to the carrying value of the preferred stock and reduced the income applicable to common shareholders reported in the calculation of earnings per share.

**Common Stock**

***Stockholders Agreement***

Concurrently with the execution of the Recapitalization Agreement, on July 30, 2010, the Company entered into a Stockholders Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors of the Company, and Larry Dyne, President of the Company ("Messrs. Schnell and Dyne"), pursuant to which:

CVC agreed that in connection with any director nominees to be submitted to holders of the Company's common stock for election at a stockholders' meeting, a committee of our Board comprised solely of directors then serving on the Board who were not elected or appointed by holders of Series B Preferred Stock, acting by majority vote, would have the right to designate all of the Board's nominees for director to be elected by holders of the Company's Common Stock.

CVC agreed that in connection with any election of directors submitted to the Company's stockholders for election at a stockholders' meeting, CVC would attend the stockholders' meeting, in person or by proxy, and vote (or cause to be voted) all of CVC's shares of the Company's voting stock in favor of the Board's nominees for director.

Messrs. Schnell and Dyne granted CVC a right of first refusal with respect to any shares of the Company's voting securities that Messrs. Schnell and Dyne proposed to sell in a private placement transaction, and agreed to provide CVC with advance notice of their intent to sell the Company's voting securities in any public sale transaction.

CVC granted Messrs. Schnell and Dyne a tag-along right, providing Messrs. Schnell and Dyne with the right to sell their shares of the Company's voting securities in a transaction where CVC is selling its shares of the Company's voting securities.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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Messrs. Schnell and Dyne agreed with CVC to vote their shares of Talon voting stock in favor of a merger or consolidation of the Company into or with another corporation or any share exchange, business combination or other such transaction in which the Company was a constituent party, or any sale of all or substantially all of the Company's assets (a "Triggering Transaction"), in each case to the extent such transaction was first approved by CVC.

CVC agreed not to sell or otherwise transfer its shares of the Company's voting securities, or to vote its shares of the Company's voting securities in favor of any Triggering Transaction, at any time on or before July 31, 2011, other than in connection with a transaction that was approved by a majority of the Company's voting shares (where, in calculating such majority, the votes attributable to CVC's shares of the Company's voting securities were excluded in the numerator but included in the denominator).

The Company provided CVC with a preemptive right, pursuant to which CVC would have the right, subject to certain exceptions set forth in the Stockholders Agreement, to acquire in a subsequent issuance of securities by the Company a number of offered securities that will allow CVC to maintain its percentage ownership of the Company's voting securities.

CVC agreed with Messrs. Schnell and Dyne that in connection with a Triggering Transaction, CVC, and any other holder of Series B Preferred Stock and shares of common stock acquired upon conversion thereof, would pay to Messrs. Schnell and Dyne a portion (beginning at 5% and increasing to 10%) of the sales proceeds payable in the Triggering Transaction to CVC or such other holder in respect of such Series B Preferred Stock or conversion shares. Each of Messrs. Schnell and Dyne's right to receive such portion of the sales proceeds was conditional upon the Triggering Transaction occurring (i) while employed by the Company or (ii) within 12 months following termination of employment with the Company for any reason other than termination of employment for "cause" or termination of employment by Messrs. Schnell or Dyne without "good reason" (as such terms are defined in their respective employment agreements).

Pursuant to the Redemption Agreement entered into on July 12, 2013, the Stockholders Agreement was terminated.

On November 8, 2013, the Company's stockholders approved an amendment to the Company's Certificate of Incorporation to increase the number of shares of common stock authorized to be issued by the Company from 100,000,000 to 300,000,000. The stockholders approved an amendment to the Company's Certificate of Incorporation to allow for a reverse split of the Company's outstanding shares of common stock as described in the proxy statement, when and if the Board of Director's determines that such action is appropriate.

*Private Placement of Common Stock*

In order to provide additional funds necessary for the redemption of the Series B Preferred Stock, on July 12, 2013 the Company raised \$5,500,000 of new equity capital through the offer and sale, in a private placement transaction, of 61,111,109 shares of the Company's common stock at a price of \$0.09 per share. The closing of the private placement was expressly conditioned upon the contemporaneous closing of the transactions under the Redemption Agreement. The closing price of the Company's common stock was \$0.058 per share on Friday, July 12, 2013, the last trading day prior to public announcement of the equity financing and redemption transactions.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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At the closing of the private placement, the Company entered into a series of Subscription Agreements (the “Subscription Agreements”) with each of the purchasers. The Subscription Agreement entered into with Kutula Holdings Ltd. (“Kutula”) grants Kutula the right to nominate one member of the Company’s Board of Directors, so long as Kutula continues to hold at least 15,500,000 of the shares (as adjusted for stock splits and the like) purchased pursuant to its Subscription Agreement, subject to certain disclosure requirements and other limitations.

The Company also entered into a Registration Rights Agreement with the investors in the transaction (the “Registration Rights Agreement”). The Registration Rights Agreement provides for demand registration rights, such that upon the demand of holders of at least 25% of the shares issued in the private placement and subject to certain conditions, the Company will file a registration statement covering the shares issued in the private placement and requested to be included in such registration. The Registration Rights Agreement also provides certain piggyback rights, in which the holders of shares acquired in the private placement have the right to include those shares in a Company-initiated registration.

**Note 10. Stock-Based Compensation**

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

**Stock Options**

As of September 30, 2013, the Company’s 2008 Stock Incentive Plan, as amended in November 2010, which was approved by the Company’s stockholders, authorized up to 4,810,000 shares of common stock that may be issued

pursuant to awards granted under the plan. On November 8, 2013, the Company's stockholders approved an amendment to the Company's 2008 Stock Incentive Plan to increase from 4,810,000 to 15,000,000 the number of shares of common stock that may be issued pursuant to awards thereunder.

The Company's 2007 Stock Plan was approved by the Company's stockholders in 2007, and replaced the 1997 Stock Plan. The 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan.

On October 1, 1997, the Company adopted the 1997 Stock Incentive Plan, which authorized the granting of a variety of stock-based incentive awards.

The Board of Directors, who determines the recipients and terms of the award granted, administers the Company's stock plan. Awards under the Company's stock plans are generally granted with an exercise price equal to the average market price of the Company's stock for the five trading days following the date of approval of the grant. Those option awards generally vest over periods determined by the Board from immediate to 4 years of continuous service and have 10 year contractual terms.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Options to purchase 400,000 shares of common stock were granted under the Stock Incentive Plans during the three months ended September 30, 2013 and no options were granted during the three months ended September 30, 2012. Options to purchase 400,000 and 630,000 shares of common stock were granted under the Stock Incentive Plans during the nine months ended September 30, 2013 and 2012, respectively.

As of September 30, 2013, the Company had \$158,409 of unamortized stock-based compensation expense related to options issued to employees and directors, which will be recognized over the weighted average period of 1.3 years. As of September 30, 2012, unamortized stock-based compensation expense related to options issued to employees and directors was \$95,324, which was to be recognized over the weighted average period of approximately 2.0 years.

The following table summarizes the activity in the Company's share based plans during the nine months ended September 30, 2013.

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
<b><i>Employees and Directors</i></b>		
Options outstanding - January 1, 2013	6,372,100	\$ 0.21
Granted	-	\$ -
Cancelled	(287,500 )	\$ 0.87
Options outstanding - June 30, 2013	6,084,600	\$ 0.18
Granted	400,000	\$ 0.28
Cancelled	(250,000 )	\$ 0.07
Options outstanding - September 30, 2013	6,234,600	\$ 0.19

**Restricted Stock Units (RSU's)**

On July 30, 2010, the Company awarded each of Lonnie Schnell and Larry Dyne a restricted stock unit award (an "RSU Award") for 5,778,500 shares of the Company's common stock. Each RSU Award vested 50% on August 30, 2011, and 10% on each date which is 18, 24, 30, 36 and 42 months following the grant date, subject to partial acceleration of vesting as part of the executives' severance benefits and full acceleration of vesting upon a change in control of the Company. As of July 30, 2010, the RSU's were valued at \$2,263,384, which was reduced by the fair value of the options surrendered by the employees in connection with these grants.

On August 30, 2010, Messrs. Schnell and Dyne elected to defer the settlement in common shares of 5,434,200 RSU's beyond the vesting dates. On July 12, 2013, 4,745,600 shares of common stock were issued upon settlement of previously vested restricted stock units pursuant to the deferral elections.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Below is a breakdown of date, issued common shares upon settlement of vested units under the RSU Awards and the related intrinsic value of these shares:

	<b>Number of RSU's</b>		<b>Intrinsic value at the time of issuance</b>	<b>Shares remaining to be issued</b>
	<b>Total RSU's awarded</b>	<b>Common shares issued</b>		
July 30, 2010	11,557,000		\$ 0.196	
August 30, 2011		600,000	\$ 0.10	
January 30, 2012		900,000	\$ 0.05	
July 30, 2012		1,500,000	\$ 0.04	
January 30, 2013		1,500,000	\$ 0.04	
July 12, 2013		4,745,600	\$ 0.06	
July 30, 2013		1,155,700	\$ 0.25	
Total at September 30, 2013		10,401,300		1,155,700

As of September 30, 2013, the Company had \$150,114 of unamortized stock-based compensation expense related to RSU's, which will be recognized over the remaining weighted average period of four months.

The following table summarizes RSU's activity:

**Weighted**

	Number of RSU's			Average Grant date value per RSU
	Unvested	Vested	Total	
RSU's outstanding – December 31, 2012	3,467,100	5,089,900	8,557,000	\$ 0.196
Common stock vested	(1,155,700)	1,155,700	-	\$ 0.196
Common stock issued	-	(1,500,000)	(1,500,000)	\$ 0.196
RSU's outstanding – June 30, 2013	2,311,400	4,745,600	7,057,000	\$ 0.196
Common stock vested	(1,155,700)	1,155,700	-	\$ 0.196
Common stock issued	-	(5,901,300)	(5,901,300)	\$ 0.196
RSU's outstanding – September 30, 2013	1,155,700	-	1,155,700	\$ 0.196



**TALON INTERNATIONAL, INC.**

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**Note 11. Income taxes**

Provision for income taxes for the three months ended September 30, 2013 and 2012 was \$228,328 and \$182,417, respectively. Provision for income taxes for the nine months ended September 30, 2013 and 2012 was \$482,161 and \$175,685, respectively. The provision for income taxes for the nine months ended September 30, 2013 included the benefit of the elimination of a tax liability of \$135,177 recorded in 2007 in connection with a tax position that could have been subject to reversal upon a regulatory review. At March 31, 2013 the time limit for regulatory assessment of the tax position expired and the liability was removed. The provision for income taxes for the nine months ended September 30, 2012 included the elimination of a tax liability of \$196,423 also recorded in 2007, for which the time limit for regulatory review had expired.

U.S. deferred income tax benefits and a portion of foreign income tax benefits, were fully reserved and not recorded in the net deferred tax assets primarily because there is not sufficient evidence to determine that the Company will be able to utilize its net operating loss carryforwards to offset future taxable income.

Other tax liabilities were principally associated with foreign withholdings and funds transfers, and income tax payable from our Asia operations. Other tax liabilities as of September 30, 2013 and December 31, 2012 totaled \$550,568 and \$111,235, respectively, and were included in Accrued Expenses.

Current income taxes receivable were associated with foreign and domestic prepayments and totaled \$186,378 and \$178,043 as of September 30, 2013 and December 31, 2012, respectively.

Long term deferred income tax liabilities totaled \$1,053,860 and \$945,543 as of September 30, 2013 and December 31, 2012, respectively. The deferred income tax liability is primarily a tax basis difference related to the Company's indefinite lived intangible asset.

On July 12, 2013, the Company entered into the Redemption Agreement with its preferred shareholder and completed a private placement transaction in which it sold 61,111,109 shares of Common stock. As consequence of these transactions the Company is currently evaluating the application of I.R.C. Section 382 concerning changes in ownership and the potential impact on the Company's utilization of the net operating loss carryforwards to offset future taxable income, including the continued appropriateness of the valuation reserves which have been established offsetting this deferred tax asset as a consequence of previous operating losses.

**Note 12. Commitments and Contingencies**

The Company currently has pending claims and complaints that arise in the ordinary course of the Company's business. The Company believes that it has meritorious defenses to these claims and that the claims are either covered by insurance or would not have a material effect on the Company's consolidated financial position or results of operations if adversely determined against the Company.

In November 2002, the FASB issued Topics of the FASB ASC 460-10, "*Guarantees*" ("ASC 460-10") and FASB ASC 850-10, "*Related Party Disclosures*" ("ASC 850-10"). The following is a summary of the Company's agreements that it has determined are within the scope of ASC 460-10 and ASC 850-10:

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

In accordance with the bylaws of the Company, and indemnification agreements entered into with the members of the board of directors and executive officers, the Company's officers and directors are indemnified for certain events or occurrences arising as a result of the officer or director's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws and indemnification agreements is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws and indemnification agreements is minimal and therefore, the Company has not recorded any related liabilities.

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

**Note 13. Segment Reporting and Geographic Information**

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

**Three Months ended September 30, 2013**

	<b>Talon</b>	<b>Trim</b>	<b>Tekfit</b>	<b>Consolidated</b>
Net sales	\$ 7,876,046	\$ 5,826,090	\$ 25,901	\$ 13,728,037
Cost of goods sold	5,546,837	3,574,398	22,420	9,143,655
Gross profit	\$ 2,329,209	\$ 2,251,692	\$ 3,481	4,584,382
Operating expenses				3,645,357
Income from operations				\$ 939,025

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)****Three Months ended September 30, 2012**

	<b>Talon</b>	<b>Trim</b>	<b>Tekfit</b>	<b>Consolidated</b>
Net sales	\$5,730,650	\$5,547,930	\$10,137	\$11,288,717
Cost of goods sold	4,152,514	3,478,455	6,876	7,637,845
Gross profit	\$1,578,136	\$2,069,475	\$3,261	3,650,872
Operating expenses				3,275,640
Income from operations				\$375,232

**Nine Months ended September 30, 2013**

	<b>Talon</b>	<b>Trim</b>	<b>Tekfit</b>	<b>Consolidated</b>
Net sales	\$23,178,408	\$17,289,453	\$40,890	\$40,508,751
Cost of goods sold	16,319,503	10,845,890	31,058	27,196,451
Gross profit	\$6,858,905	\$6,443,563	\$9,832	13,312,300
Operating expenses				10,575,799
Income from operations				\$2,736,501

**Nine Months ended September 30, 2012**

	<b>Talon</b>	<b>Trim</b>	<b>Tekfit</b>	
Net sales	\$17,074,745	\$16,124,630	\$15,141	\$33,214,516
Cost of goods sold	12,292,511	10,112,403	29,245	22,434,159
Gross profit (loss)	\$4,782,234	\$6,012,227	\$(14,104)	10,780,357
Operating expenses				9,904,593
Income from operations				\$875,764



**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

The Company distributes its products internationally and has reporting requirements based on geographic regions. Revenues are attributed to countries based upon customer delivery locations and the net book value of long-lived assets (consisting of property and equipment and intangible) is attributed to countries based on the location of the assets, as follows:

<i>Sales:</i> <i>Country / Region</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>2012</b>	<b>September 30, 2013</b>	<b>2012</b>
United States	\$1,157,394	\$1,369,612	\$3,065,152	\$3,237,883
China	4,322,596	2,634,915	12,209,535	8,279,337
Hong Kong	4,012,930	3,884,128	11,127,379	10,989,010
Other	4,235,117	3,400,062	14,106,685	10,708,286
Total	\$13,728,037	\$11,288,717	\$40,508,751	\$33,214,516

<i>Long-lived Assets:</i>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
	United States	\$4,547,058
Hong Kong	358,662	419,268
China	84,241	73,344
Total	\$4,989,961	\$5,043,713

**Note 14. Related Party Transactions**

On July 12, 2013, the Company entered into the Redemption Agreement with CVC (our controlling stockholder at the time) and repurchased from CVC all of the 407,160 previously outstanding shares of our Series B Preferred Stock for an aggregate purchase price of \$18,800,000, which purchase price was paid by delivery to CVC of \$13,000,000 in cash and an unsecured Promissory Note in the principal amount of \$5,800,000. Pursuant to the Redemption Agreement, the Stockholder's Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors of the Company, and Larry Dyne, President of the Company was terminated.

In connection with the redemption in full of the Series B Preferred Stock, CVC representative on the Company Board of Directors, Mark Hughes, resigned from Board of Directors effective July 12, 2013.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

In order to provide additional funds necessary for the redemption of the Series B Preferred Stock, the Company raised \$5,500,000 of new equity capital through the sale, in a private placement transaction, of 61,111,109 shares of common stock at a price of \$0.09 per share. The closing of the private placement was expressly conditioned upon the contemporaneous closing of the transactions under the Redemption Agreement. Zipper Holdings, LLC, a company controlled by Mark Dyne, the Chairman of our Board of Directors, acquired 8,333,333 shares of common stock in the private placement. At the closing of the private placement, the Company entered into Subscription Agreements (the "Subscription Agreements") with each of the purchasers. The Company also entered into a Registration Rights Agreement with the investors in the transaction (the "Registration Rights Agreement"). The Registration Rights Agreement provides for demand registration rights, such that upon the demand of holders of at least 25% of the shares issued in the private placement and subject to certain conditions, the Company will file a registration statement covering the shares issued in the private placement and requested to be included in such registration. The Registration Rights Agreement also provides certain piggyback rights, in which the holders of shares acquired in the private placement have the right to include those shares in a Company-initiated registration.

**Note 15. Subsequent Events**

The Company evaluated subsequent events after the balance sheet date of September 30, 2013 through the date of the filing of this report.

On November 8, 2013, the Company's stockholders approved an amendment to the Company's Certificate of Incorporation to increase the number of shares of common stock authorized to be issued by the Company from 100,000,000 to 300,000,000; an amendment to the Company's Certificate of Incorporation to allow for a reverse split of the Company's outstanding shares of common stock, when and if the Board of Director's determine that such an action would be appropriate; and an amendment to the Company's 2008 Stock Incentive Plan to increase from 4,810,000 to 15,000,000 the number of shares of common stock that may be issued pursuant to awards under the plan.



## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Forward Looking Statements**

### **Overview**

This report and other documents we file with the Securities and Exchange Commission contain forward looking statements that are based on current expectations, estimates, forecasts and projections about us, our future performance, our business or others on our behalf, our beliefs and our management's assumptions. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. We describe our respective risks, uncertainties, and assumptions that could affect the outcome or results of operations below. We have based our forward looking statements on our management's beliefs and assumptions based on information available to our management at the time the statements are made. We caution you that actual outcomes and results may differ materially from what is expressed, implied, or forecast by our forward looking statements. Reference is made in particular to forward looking statements regarding projections or estimates concerning our business, including adequate liquidity to fund our operations and meet our other cash requirements, ability to refinance existing indebtedness, demand for our products and services, mix of revenue streams, ability to control or reduce operating expenses, anticipated gross margins and operating results, cost savings, product development efforts, general outlook of our business and industry, international businesses, and competitive position.

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

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

We pursue the global expansion of our business through the establishment of Talon owned sales and distribution locations, and strategic manufacturing relationships. The manufacturing arrangements, in combination with Talon owned and affiliated facilities under the Talon brand, improve our time-to-market throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets.

Our primary business focus is on serving as an outsourced apparel zipper and trims supplier, product design and development, sampling and sourcing department for the most demanding brands and retailers. We believe that design differentiation among brands and retailers is a critical marketing tool for our customers. By assisting our customers in the design, development, sampling and sourcing of all trim components, we generally achieve higher margins for our products, create long-term relationships with our customers, grow our sales to a particular customer by serving a larger proportion of their brands and better differentiate our sales and services from those of our competitors. We are expanding our business globally, to better serve our apparel customers in the field, in addition to our brand and retail customer. We believe we can lead the industry in apparel accessories by having strong relationships with our brand and retail customers and having a distributed service organization to serve our factory customers globally.

Our *Tekfit* business provides manufacturers with patented technology, manufacturing know-how, equipment and materials required to produce a stretchable waistband. Sales of this product in recent years have been limited by a licensing dispute. However, we entered into a Settlement Agreement and Release in March 2012 that included an unconditional release from all lawsuits, claims, and liabilities and resulted in our obtaining full ownership to all U.S. patents technology rights and intellectual property. Accordingly, following settlement of the dispute we began to actively expand our marketing and selling efforts of this unique product and brand within the industry.

### **Recent Developments**

On July 12, 2013 we entered into a Redemption Agreement with CVC. Pursuant to the Redemption Agreement, we repurchased from CVC all of the 407,160 outstanding shares of Series B Preferred Stock for an aggregate purchase price of \$18,800,000, which purchase price was paid by delivery to CVC of \$13,000,000 in cash and an unsecured Promissory Note in the principal amount of \$5,800,000.

The Promissory Note accrues interest in the amount of 1% per annum, is due and payable in full on January 12, 2014, and includes discounts for early repayments that decrease over time. The Promissory Note further requires mandatory prepayments equal to a specified portion of the proceeds received by the Company with respect to future secured debt financing transactions, as well as customary default provisions. We are in the process of pursuing additional debt financing in order to repay the Promissory Note on or prior to its maturity date.

In order to provide additional funds necessary for the redemption of the Series B Preferred Stock, on July 12, 2013 we raised \$5,500,000 of new equity capital through the offer and sale, in a private placement transaction, of 61,111,109 shares of our common stock at a price of \$0.09 per share. The closing of the private placement was expressly conditioned upon the contemporaneous closing of the transactions under the Redemption Agreement.

The redemption of the preferred shares removed our liquidation preference obligation of \$25.9 million, which entitled the preferred shareholders to payment of the preference amount before payment to the common stockholders. The liquidation preference was scheduled to increase to \$40.7 million at the time the preferred shares became mandatorily redeemable in 2016. The removal of this obligation resulted in an immediate benefit to common stockholders of approximately \$6.9 million net of related costs of the transaction, and also eliminated the obligation to redeem the Series B Preferred Stock in the future. We now have only common shares outstanding.

### **Seasonality**

We typically experience seasonal fluctuations in sales volume consistent with the purchase demands of the apparel industry. In most years, these seasonal fluctuations result in lower sales volumes for our business in the first and

fourth quarters of each year due to the seasonal buying patterns by the majority of our customers. The apparel retailers typically experience higher sales volumes during the second and third quarters associated with back-to-school sales efforts and in the fourth quarter in connection with year-end holiday purchases. Sales of our products typically precede the retail sales patterns by 90 to 150 days. Backlogs of sales orders are not considered material in the industries in which we compete, which reduces the predictability of our sales and reinforces the volatility of these cyclical buying patterns on our sales volume.

## Results of Operations

The following table sets forth selected statements of operations data shown as a percentage of net sales for the periods indicated:

	<b>Three Months Ended September 30, 2013</b>		<b>Nine Months Ended September 30, 2012</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	66.6	67.7	67.1	67.5
Gross profit	33.4	32.3	32.9	32.5
Sales and marketing expenses	11.4	10.7	10.8	10.4
General and administrative expenses	15.2	18.3	15.4	19.4
Interest expense, net	0.0	0.0	0.0	0.2
Provision for taxes, net	1.7	1.6	1.2	0.5
Net income	5.1 %	1.7 %	5.5 %	2.0 %

### Sales

For the three and nine months ended September 30, 2013 and 2012, sales by geographic region based on the location of the customer as a percentage of sales were as follows:

<b>Region</b>	<b>Three Months Ended September 30, 2013</b>		<b>Nine Months Ended September 30, 2012</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
United States	8.4 %	12.1 %	7.6 %	9.7 %
China	31.5	23.3	30.1	24.9
Hong Kong	29.2	34.4	27.5	33.1
Other	30.9	30.2	34.8	32.3
	100.0%	100.0%	100.0%	100.0%

Sales for the three months ended September 30, 2013 were \$13,728,000, an increase of \$2,439,000 or 21.6% compared to the same period in 2012. Sales for the nine months ended September 30, 2013 were \$40,509,000, an increase of \$7,294,000 or 22.0% compared to the same period in 2012. The increases in both periods reflected higher

sales to our Specialty Retail Branded customers in the Zipper and Trim segments, and sales to new customers in all three business segments. Our Zipper Products segment increased sales by \$2,145,000 and \$6,104,000 for the three and nine months ended September 30, 2013, respectively, compared to the same periods in 2012. The Trim Products segment increased sales by \$278,000 and \$1,165,000 for the three and nine months ended September 30, 2013, respectively, compared to the same periods in 2012.

### *Gross Profit*

Gross profit for the three months ended September 30, 2013 was \$4,584,000 and 33.4% of sales, reflecting an increase of \$934,000 or 25.6% as compared to the same period in 2012. Gross profit for the nine months ended September 30, 2013 was \$13,312,000 and 32.9% of sales, reflecting an increase of \$2,532,000 or 23.5% as compared to the same period in 2012. The increase in gross profit for the three and nine months ended September 30, 2013 as compared to the same period in 2012 was principally attributable to greater overall sales volumes in all business segments and improved product mix, partially offset by higher manufacturing support, freight and duty costs.



A recap of the change in gross profit for the three and nine months ended September 30, 2013 as compared with the same period in 2012 is as follows:

	<b>Three Months Ended September 30, 2013 compared to same period in 2012</b>		<b>Nine Months Ended September 30, 2013 compared to same period in 2012</b>	
	<b>\$(<sup>(1)</sup>)</b>	<b>%(<sup>(1)</sup>)</b>	<b>\$(<sup>(1)</sup>)</b>	<b>%(<sup>(1)</sup>)</b>
<b>Gross profit changes as a result of:</b>				
Higher sales volumes	1,006,000	27.5	3,010,000	27.9
Improved mix of products	180,000	4.9	189,000	1.7
Higher freight and duty costs	(77,000 )	(2.1 )	(215,000 )	(2.0 )
Higher manufacturing overhead costs	(175,000 )	(4.7 )	(452,000 )	(4.1 )
Gross profit change	934,000	25.6	2,532,000	23.5

(<sup>1</sup>) Represents the amount or percentage, as applicable, of change in each item in the three and nine months ended September 30, 2013 period as compared to the same period in 2012.

#### *Sales and marketing expenses*

Sales and marketing expenses for the three months ended September 30, 2013 totaled \$1,568,000, an increase of \$363,000 as compared to same period in 2012. Sales and marketing expenses for the nine months ended September 30, 2013 totaled \$4,365,000, an increase of \$896,000 as compared to same period in 2012. Sales and marketing expenses increased mainly due to higher sales commissions associated with the higher sales volumes, and due to increased new product development costs.

#### *General and administrative expenses*

General and administrative expenses for the three months ended September 30, 2013 totaled \$2,077,000, or 15.1% of sales, which increased by \$7,000 as compared to the same period in 2012. The increase resulted mainly from higher net compensation costs of \$161,000 and other cost increases of \$13,000, offset by lower legal fees of \$113,000 following settlement earlier this year of a legal dispute regarding protection of our trademark filings, and reduced professional services costs of \$54,000.

General and administrative expenses for the nine months ended September 30, 2013 totaled \$6,211,000, or 15.3% of sales, which was lower by \$225,000 as compared to the same period in 2012. The decline resulted mainly from receipt of a settlement of \$350,000 for a previous legal dispute regarding intellectual property rights, lower legal fees of \$348,000 associated with our efforts to protect worldwide trademark filings, reduced professional services and recruiting expenses of \$156,000, offset by higher net compensation costs of \$604,000 and other cost increases of \$25,000.

*Interest expense and interest income*

Interest expense for the three and nine months ended September 30, 2013 was \$12,000 and \$14,000, respectively, as compared to interest expense for the three and nine months ended September 30, 2012 of \$7,000 and \$51,000, respectively. Interest income for the three and nine months ended September 30, 2013 and 2012 was \$1,000 and \$3,000, respectively.

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

	<b>Three Months Ended September 30, 2013</b>		<b>Nine Months Ended September 30, 2012</b>	
Amortization of deferred financing costs	\$-	\$3,000	\$-	\$18,000
Other interest expense	12,000	4,000	14,000	33,000
Interest expense	12,000	7,000	14,000	51,000
Interest income	(1,000 )	(1,000 )	(3,000 )	(3,000 )
Interest expense, net	\$11,000	\$6,000	\$11,000	\$48,000

#### *Income taxes*

Provision for income taxes, net for the three months ended September 30, 2013 and 2012 was \$228,000 and \$182,000, respectively. Provision for income taxes, net for the nine months ended September 30, 2013 and 2012 was \$482,000 and \$176,000, respectively. The benefit from income taxes for the nine months ended September 30, 2013 included the elimination of a tax liability of \$135,177, recorded in 2007, for a tax position that could have been subject to reversal upon a regulatory review. At March 31, 2013 the time limit for regulatory assessment of the tax position expired and the liability was removed. The benefit from income taxes for the nine months ended September 30, 2012 included the elimination of a tax liability of \$196,423 also recorded in 2007, for which the time limit for regulatory review had expired.

Deferred income tax assets, net are not reflected in our financial position, since there has not been sufficient evidence to ensure that it is more likely than not that we will be able to utilize our domestic U.S. operating loss carry forwards (as well as a portion of our foreign net operating loss carry forwards) to offset future taxable income, and accordingly the tax benefit of these losses is offset by a full valuation reserve.

On July 12, 2013 we entered into a Redemption Agreement with our Preferred Shareholder and completed a private placement transaction in which we sold 61,111,109 shares of Common stock. As a consequence of these transactions we are currently evaluating the application of I.R.C. Section 382 concerning changes in ownership and the potential impact this may have on our utilization of the net operating loss carry-forwards to offset future taxable income, including the continued appropriateness of the valuation reserves which have been established offsetting this deferred tax asset as a consequence of previous operating losses.



## Liquidity and Capital Resources

The following table summarizes selected financial data at:

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Cash and cash equivalents	\$3,975,000	\$8,927,000
Total assets	\$14,239,000	\$18,976,000
Current liabilities	\$16,144,000	\$9,893,000
Long term liabilities	\$1,082,000	\$1,132,000
Preferred stock	\$-	\$23,979,000
Stockholders' equity (deficit)	\$(2,986,000 )	\$(16,028,000)
Total equity and preferred stock	\$(2,986,000 )	\$7,951,000

On July 12, 2013, we entered into a Redemption Agreement and in connection with this preferred stock redemption used \$7.5 million of our cash on hand, in addition to \$5.5 million of proceeds from the sale of newly issued shares of common stock, to repurchase all of the outstanding preferred shares. In addition to the cash purchase price, we also issued the previous holder of the preferred shares a Promissory Note in the principal amount of \$5.8 million that matures in January 2014. We expect to refinance all or part of the \$5.8 million Promissory Note issued in connection with the Redemption Agreement prior to its maturity in January 2014. However, there can be no assurance that we will be able to obtain additional debt financing on favorable terms.

Assuming we are able to refinance the \$5.8 million Promissory Note on acceptable terms, we believe that our remaining cash and cash equivalents and our anticipated cash flows from our operating activities will be sufficient to fund our minimum working capital and capital expenditure needs for operating activities for at least the next twelve months.

### *Cash and cash equivalents*

Cash and cash equivalents declined by \$4,952,000 at September 30, 2013 as compared to December 31, 2012, principally due to our redemption of the Series B Preferred Stock for \$18,800,000, net of the proceeds from the sale of common stock of \$5,500,000, and the issuance of a note payable of \$5,800,000 in conjunction with the redemption and the acquisition of property and equipment of \$316,000, offset by the cash provided by operating activities of

\$3,104,000.

Cash provided by operating activities is our primary recurring source of funds, and reflects the net income from operations excluding non-cash charges, and changes in operating capital. The nine months ended September 30, 2013 and 2012 reflected net cash provided by operating activities of \$3,104,000 and \$1,742,000, respectively.

The net cash provided by operating activities during the nine months ended September 30, 2013 and 2012 resulted principally from:

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>
Net income before non-cash expenses	\$3,173,000	\$1,651,000
Reduced (increased) inventory	(287,000 )	363,000
Reduced (increased) accounts receivable	109,000	(605,000 )
Increased accounts payable and accrued expenses	400,000	771,000
Other (reductions) in operating capital	(291,000 )	(438,000 )
Cash provided by operating activities	\$3,104,000	\$1,742,000

Net cash used in investing activities for the nine months ended September 30, 2013 and 2012 was \$314,000, and \$348,000, respectively, due to the acquisition of property and equipment of \$316,000 and \$173,000, respectively, and the acquisition of intangibles in 2012 of \$175,000 offset by proceeds from the sale of equipment in amount of \$2,000 and \$168 respectively.

Net cash used in financing activities for the nine months ended September 30, 2013 and 2012 was \$7,820,000 and \$311,000, respectively, reflecting the redemption of Series B Preferred Stock of \$18,800,000 net of the proceeds from the sale of stock of \$5,500,000 and the issuance of a note payable of \$5,800,000 in 2013; the associated costs of issuance for the stock and redemption of the preferred shares of \$163,000 and \$154,000, respectively in 2013; and payment of notes payable to related parties and other notes payable in the amount of \$241,000 and \$67,000, respectively during 2012; together with the repayment of borrowings under capital leases during 2013 and 2012 of \$2,000 and \$3,000, respectively.

We have financed equipment purchases through capital lease obligations. Our equipment financing obligation as of September 30, 2013 was approximately \$1,000 and bore interest at rate of 15.4% per annum. Under these obligations, we are required to make monthly payments of principal and interest through November 2013.

We have satisfied our working capital requirements primarily through cash flows generated from operations and borrowings under our credit facility. As we continue to expand globally with our apparel manufacturing in offshore locations, our customers are substantially all foreign-based and foreign-owned entities. We continue to evaluate both financing and equity options to provide capital to refinance our outstanding short-term debt and, if needed, to fund our expansion and on-going operations. If we experience greater than anticipated reductions in sales, we may need to borrow or raise additional capital, or further reduce the scope of our business in order to fund our on-going operations or to satisfy our future short-term operating requirements. The extent of our future long-term capital requirements will

depend on many factors, including our results of operations, future demand for our products, the size and timing of possible acquisitions, and our expansion into foreign markets. Our need for additional long-term financing may include the integration and expansion of our operations to exploit our rights under our Talon and Tekfit trade names, and the expansion of our operations in the Asian and European markets. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise debt or equity financing in order to provide for our operations.



**Contractual Obligations and Off-Balance Sheet Arrangements**

The following summarizes our contractual obligations at September 30, 2013:

<b>Contractual Obligations</b>	<b>Payments Due by Period (\$)</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 years</b>
Note payable	\$5,829,000	5,829,000	\$-	\$-	\$ -
Operating leases	3,014,000	1,273,000	1,715,000	26,000	-
Capital lease obligations	1,000	1,000	-	-	-
Total Obligations	\$8,844,000	\$7,103,000	\$1,715,000	\$26,000	\$ -

At September 30, 2013 and December 31, 2012, we did not have any relationships with unconsolidated entities or financial partnerships (such as entities often referred to as structured finance or special purpose entities), which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we do not have any of the risks associated with financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

**Related Party Transactions**

On July 12, 2013, we entered into the Redemption Agreement with CVC (our controlling stockholder at the time) and repurchased from CVC all of the 407,160 previously outstanding shares of our Series B Preferred Stock for an aggregate purchase price of \$18,800,000, which purchase price was paid by delivery to CVC of \$13,000,000 in cash and an unsecured Promissory Note in the principal amount of \$5,800,000. Pursuant to the Redemption Agreement, the Stockholder's Agreement with CVC, and with Lonnie D. Schnell, Chief Executive Officer, Chief Financial Officer and a member of the Board of Directors of the Company, and Larry Dyne, President of the Company was terminated.

In connection with the redemption in full of the Series B Preferred Stock, CVC representative on the Company Board of Directors, Mark Hughes, resigned from Board of Directors effective July 12, 2013.

In order to provide additional funds necessary for the redemption of the Series B Preferred Stock, we raised \$5,500,000 of new equity capital through the sale, in a private placement transaction, of 61,111,109 shares of common stock at a price of \$0.09 per share. The closing of the private placement was expressly conditioned upon the contemporaneous closing of the transactions under the Redemption Agreement. Zipper Holdings, LLC, a company controlled by Mark Dyne, the Chairman of our Board of Directors, acquired 8,333,333 shares of common stock in the private placement. At the closing of the private placement, we entered into Subscription Agreements (the "Subscription Agreements") with each of the purchasers. We also entered into a Registration Rights Agreement with the investors in the transaction (the "Registration Rights Agreement"). The Registration Rights Agreement provides for demand registration rights, such that upon the demand of holders of at least 25% of the shares issued in the private placement and subject to certain conditions, we will file a registration statement covering the shares issued in the private placement and requested to be included in such registration. The Registration Rights Agreement also provides certain piggyback rights, in which the holders of shares acquired in the private placement have the right to include those shares in a Company-initiated registration.

## Application of Critical Accounting Policies and Estimates

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

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

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

The net bad debt expense, net and allowances for the three and nine months ended September 30, 2013 and 2012 are as follows:

	<b>Three Months Ended September 30, 2013</b>		<b>Nine Months Ended September 30, 2012</b>	
Bad debt expense (recovery), net	\$(2,000 )	\$(8,000 )	\$19,000	\$5,000
Allowance for doubtful accounts, Accounts receivable	\$21,000	\$48,000	\$21,000	\$48,000

Inventories are stated at the lower of cost, determined using the first-in, first-out ("FIFO") basis, or market value and are all substantially finished goods. The costs of inventory include the purchase price, inbound freight and duties,

conversion costs and certain allocated production overhead costs. Inventory is evaluated on a continual basis and reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Inventory reserves are recorded for damaged, obsolete, excess, impaired and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory. Inventory reserve is reduced following legacy inventory sale and write-off of reserved inventory and increased by additions to reserve for slow moving inventory.

We record deferred tax assets and liabilities arising from temporary timing differences between recorded net income and taxable net income when and if we believe that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. If we determine that we may not realize all of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. A deferred income tax liability related to indefinite lived intangibles should not be offset against deferred income tax assets. We believe that our estimate of deferred tax assets and liabilities and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. See Note 11 in the accompanying Notes to Consolidated Financial Statements.

Sales are recognized when persuasive evidence of an arrangement exists, product title has passed, pricing is fixed or determinable and collection is reasonably assured. Sales resulting from customer buy-back agreements, or associated inventory storage arrangements are recognized upon delivery of the products to the customer, the customer's designated manufacturer, or upon notice from the customer to destroy or dispose of the goods. Sales, provisions for estimated sales returns, and the cost of products sold are recorded at the time title transfers to customers. Actual product returns are charged against estimated sales return allowances, which returns have been insignificant.

We are currently involved in various lawsuits, claims and inquiries, most of which are routine to the nature of the business and in accordance with FASB ASC 450, "Contingencies". We accrue estimates of the probable and estimable losses for the resolution of these claims. The ultimate resolution of these claims could affect our future results of operations for any particular quarterly or annual period should our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued. We believe that we have meritorious defenses to these claims and that the claims are either covered by insurance or would not have a material effect on our consolidated financial position or results of operations if adversely determined against us.

### **New Accounting Pronouncements**

In July 2013, the FASB issued ASU 2013-11, "*Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*" ("ASU 2013-11"), which sets forth explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This guidance is effective for fiscal years, and interim periods beginning after December 15, 2013, with early adoption permitted. We adopted ASU 2013-011 as of September 30, 2013 with no impact on the consolidated financial statements.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Not Applicable.

#### **Item 4. Controls and Procedures**

##### **Evaluation of Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act.

As of the end of the period covered by this report, management, with the participation of Lonnie D. Schnell, our principal executive officer and principal financial officer, and James E. Reeder, our principal accounting officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, Mr. Schnell and Mr. Reeder concluded that these disclosure controls and procedures were effective as of the end of the period covered in this Quarterly Report on Form 10-Q.

##### **Changes in Internal Control over Financial Reporting**

During the quarter ended September 30, 2013, there were no changes in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

On May 7, 2012, we filed a lawsuit against Adidas America, Inc. in the U.S. District Court for the Central District of California asserting claims of trademark infringement, unfair competition, deceptive trade practices and related claims, under both U.S. and California law. The claims arose out of Adidas's use of the "Techfit" name for its apparel, which we asserted infringed our previously registered Tekfit trademark. On May 21, 2012, Adidas then filed a counterclaim against Talon seeking cancellation of our Tekfit U.S. trademark registrations and recovery of legal fees.

On January 15, 2013, we received a cash settlement from Adidas and both parties dismissed all related actions with prejudice and ensured that future use of their trademarks would not create confusion to the consumer.

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

### **Item 1A. Risk Factors**

Risk factors are contained in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. Except as set forth below, no material change to such risk factors has occurred during the nine months ended September 30, 2013.

Following the repurchase of all our previously outstanding shares of Series B Preferred Stock from CVC California LLC on July 12, 2013, we issued CVC a promissory note. The following risk factor applies after that date.

*If we are unable to refinance our short-term debt on favorable terms prior to maturity, we may be required to utilize our cash reserves or obtaining alternative financing.*



As partial consideration for the repurchase of all our previously outstanding shares of Series B Preferred Stock from CVC California LLC, we issued CVC a promissory note in the principal amount of \$5.8 million which is due and payable in January 2014. We are currently seeking additional debt financing to allow us to refinance and repay the promissory note on or prior to its maturity date. If we are unable to obtain additional debt financing on terms that we deem acceptable, we may have to use a significant portion of our current and anticipated cash to repay the CVC promissory note. In such event, our liquidity may be adversely affected. If we do not have sufficient cash or debt financing to repay the promissory note when due, we may be forced to pursue alternative debt or equity financing structures, which could have an adverse effect on our capital structure and the market price for our common stock.

**Item 6. Exhibits**

<u>Exhibit No.</u>	<u>Description</u>
10.13	Securities Redemption Agreement dated July 12, 2013 among Talon International, Inc., CVC California, LLC, Lonnie D. Schnell and Larry Dyne. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 16, 2013.
10.14	\$5,800,000 Promissory Note dated July 12, 2013 issued by Talon International, Inc. in favor of CVC California, LLC. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 16, 2013.
10.15	Subscription Agreement dated July 12, 2013 between Talon International, Inc. and Kutula Holdings Ltd. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 16, 2013.
10.16	Form of Subscription Agreement dated July 12, 2013. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 16, 2013.
10.17	Registration Rights Agreement dated July 12, 2013 among Talon International, Inc., Kutula Holdings Ltd., Perrtech Pty Limited, Zipper Holdings, LLC, Fairways Investments, LLC and Manifest Capital, LLC. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 16, 2013.
31.1	Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.DEF*	XBRL Taxonomy Extension Definition
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation

XBRL information is furnished and not filed or a part of a registration statement or prospectus for purpose of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.



## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 12, 2013 /s/ Lonnie D. Schnell

Lonnie D. Schnell

Chief Executive Officer and Chief Financial Officer

(Principal Executive Officer and Principal Financial Officer)

/s/ James E. Reeder

James E. Reeder

Vice President, Corporate Controller

(Principal Accounting Officer)