

TALON INTERNATIONAL, INC.  
Form 10-Q  
August 11, 2014

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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 June 30, 2014

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)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**95-4654481**  
(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 August 8, 2014, the issuer had 92,267,831 shares of Common Stock, \$.001 par value, issued and outstanding.

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**TALON INTERNATIONAL, INC.**

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

	<b>June 30, 2014 (Unaudited)</b>	<b>December 31, 2013</b>
Assets		
Current assets:		
Cash and cash equivalents	\$4,472,438	\$3,779,508
Accounts receivable, net	3,776,051	3,576,925
Inventories, net	651,370	800,240
Prepaid expenses and other current assets	942,712	973,836
Total current assets	9,842,571	9,130,509
Property and equipment, net	619,588	614,592
Intangible assets, net	4,260,568	4,267,110
Deferred income tax assets, net	5,794,198	6,050,402
Other assets	418,057	460,226
Total assets	\$20,934,982	\$20,522,839
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$7,798,189	\$7,158,938
Accrued expenses	2,669,545	2,880,764
Revolving credit loan	1,000,000	1,000,000
Current portion of term loan payable	1,666,667	1,666,667
Total current liabilities	13,134,401	12,706,369
Term loan payable, net of current portion	2,500,000	3,333,333
Deferred income tax liabilities	12,054	30,388
Other liabilities	15,254	22,169
Total liabilities	15,661,709	16,092,259
Commitments and contingencies (Note 11)		
Stockholders' Equity:		
Common Stock, \$0.001 par value, 300,000,000 shares authorized; 92,267,831 and 91,342,215 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	92,268	91,342
Additional paid-in capital	64,054,800	64,046,631
Accumulated deficit	(58,990,438)	(59,822,178)

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Accumulated other comprehensive income	116,643	114,785
Total stockholders' equity	5,273,273	4,430,580
Total liabilities and stockholders' equity	\$20,934,982	\$20,522,839

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Six Months Ended June	
	June 30, 2014	2013	2014	2013
Net sales	\$15,959,169	\$16,640,964	\$27,302,287	\$26,780,714
Cost of goods sold	10,553,709	11,089,124	18,161,871	18,052,796
Gross profit	5,405,460	5,551,840	9,140,416	8,727,918
Sales and marketing expenses	1,702,274	1,532,493	3,117,964	2,796,485
General and administrative expenses	2,221,622	2,430,748	4,398,693	4,133,957
Total operating expenses	3,923,896	3,963,241	7,516,657	6,930,442
Income from operations	1,481,564	1,588,599	1,623,759	1,797,476
Interest expense (income), net	109,614	(197 )	220,885	575
Income before provision for income taxes	1,371,950	1,588,796	1,402,874	1,796,901
Provision for income taxes, net	557,475	326,081	571,134	253,833
<b>Net income</b>	<b>\$814,475</b>	<b>\$1,262,715</b>	<b>\$831,740</b>	<b>\$1,543,068</b>
Series B Preferred Stock liquidation preference increase	-	(899,220 )	-	(1,798,441 )
<b>Net Income (loss) applicable to Common Stockholders</b>	<b>\$814,475</b>	<b>\$363,495</b>	<b>\$831,740</b>	<b>\$(255,373 )</b>
<b>Per share amounts:</b>				
Net income	\$0.01	\$0.05	\$0.01	\$0.06
Net income applicable to Preferred Stockholders	0.00	(0.04 )	0.00	(0.07 )
Basic and diluted net income (loss) applicable to Common Stockholders	\$0.01	\$0.01	\$0.01	\$(0.01 )
Weighted average number of common shares outstanding - Basic	92,267,831	24,900,808	92,037,571	24,652,189
Weighted average number of common shares outstanding - Diluted	93,702,693	27,521,480	93,566,946	24,652,189
<b>Net income</b>	<b>\$814,475</b>	<b>\$1,262,715</b>	<b>\$831,740</b>	<b>\$1,543,068</b>
Other comprehensive income from foreign currency translation	766	31,142	1,858	29,851
<b>Total comprehensive income</b>	<b>\$815,241</b>	<b>\$1,293,857</b>	<b>\$833,598</b>	<b>\$1,572,919</b>

See accompanying notes to consolidated financial statements.



## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	<b>Six Months Ended June</b>	
	<b>30,</b>	
	<b>2014</b>	<b>2013</b>
<i>Cash flows from operating activities:</i>		
Net income	\$831,740	\$1,543,068
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	144,780	249,608
Gain on disposal of equipment	(193 )	(1,832 )
Amortization of deferred financing cost	45,139	-
Stock based compensation	122,923	251,213
Deferred income taxes, net	237,552	72,211
Bad debt expense (recoveries), net	(9,094 )	20,859
Inventory valuation provisions, net	17,952	19,158
Changes in operating assets and liabilities:		
Accounts receivable	(193,336 )	(882,945 )
Inventories	130,809	(221,964 )
Prepaid expenses and other current assets	28,660	(72,364 )
Other assets	(2,978 )	(207,385 )
Accounts payable and accrued expenses	440,293	2,230,827
Other liabilities	(6,923 )	(143,628 )
Net cash provided by operating activities	1,787,324	2,856,826
<i>Cash flows from investing activities:</i>		
Proceeds from sale of equipment	193	1,832
Acquisitions of property and equipment	(143,773 )	(327,976 )
Net cash (used in) investing activities	(143,580 )	(326,144 )
<i>Cash flows from financing activities:</i>		
Payments of term loan payable	(833,333 )	-
Payments related to taxes on the exercise of stock options and settlement of RSUs	(143,537 )	-
Proceeds from exercise of stock options	29,709	-
Payments of capital leases	-	(1,662 )
Net cash (used in) financing activities	(947,161 )	(1,662 )
Net effect of foreign currency exchange translation on cash	(3,653 )	49,735
Net increase in cash and cash equivalents	692,930	2,578,755
Cash and cash equivalents at beginning of period	3,779,508	8,927,333
Cash and cash equivalents at end of period	\$4,472,438	\$11,506,088

See accompanying notes to consolidated financial statements.





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

Supplemental disclosures of cash flow information:

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2014</b>	<b>2013</b>
Cash received (paid) during the period for:		
Interest paid	\$(176,205)	\$(2,672 )
Interest received	\$1,336	\$2,097
Income tax received (paid), net (principally foreign)	\$42,684	\$(58,858 )
Non-cash financing activities:		
Series B preferred stock liquidation preference increase	\$-	\$(1,798,441)
Non-cash exercise of stock options and settlement of RSUs in common stock	\$649	\$1,500
Effect of foreign currency translation on net assets	\$1,858	\$29,851

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. Certain information and footnote disclosures normally included in comprehensive financial statements have been condensed or omitted pursuant to such rules and regulations, although the management of Talon International, Inc. and its consolidated subsidiaries (collectively, the “Company”) believes that the disclosures made are adequate to make the information not misleading. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

**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, 2013, 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 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 recoveries, net for the three and six months ended June 30, 2014 were \$(18,508) and \$(9,094), respectively. Bad debt expense, net for the three and six months ended June 30, 2013 was \$20,749 and \$20,859, 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:

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.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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, revolving credit loan, term loan 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 June 30, 2014 and December 31, 2013, 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 \$1,356,000 and \$961,000, 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. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements. The Company completed the required assessment as of June 30, 2014 and December 31, 2013, and noted no impairment.

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

Intangible assets as of June 30, 2014 and December 31, 2013 are as follows:

	<b>June 30, 2014</b>	<b>December 31, 2013</b>
Tradenname - Talon trademark	\$4,110,751	\$4,110,751
Intellectual property rights	178,722	178,722
Less: Accumulated amortization (10 to 17 years)	(28,905 )	(22,363 )
Intellectual property rights, net	149,817	156,359
Intangible assets, net	\$4,260,568	\$4,267,110

Amortization expense for intangible assets was \$3,271 and \$6,542 for the three and six months ended June 30, 2014, and \$3,271 and \$6,291 for the three and six months ended June 30, 2013, respectively.

***Convertible Preferred Stock***

The Company had classified its conditionally redeemable Series B Convertible Preferred shares, which were subject to redemption upon the occurrence of uncertain events not solely within the Company's control, 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 (See Note 8).

The Company evaluated the conversion option of the Series B 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. The Series B Convertible Preferred shares were initially recorded at their fair value minus the BCF and minus preferred stock issuance costs, and then were 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 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 stockholders 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 stockholders in the calculation of earnings per share.

Accordingly, the Series B Convertible Preferred shares were reported at their liquidation preference amount.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*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 quality assurance costs, 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 and other sales and product development 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.

*Interest Expense, net* – Interest expense reflects the cost of borrowings and amortization of deferred financing costs. Interest expense for the three and six months ended June 30, 2014 totaled \$110,457 and \$222,221, respectively. Interest expense for the three and six months ended June 30, 2013 totaled \$1,451 and \$2,672, respectively. Interest income consists of earnings from cash held in interest bearing accounts. For the three and six months ended June 30, 2014 the Company recorded interest income of \$843 and \$1,336, respectively. For the three and six months ended June 30, 2013 the Company recorded interest income of \$1,648 and \$2,097, 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 \$116,643 and \$114,785 as of June 30, 2014 and December 31, 2013, 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.

The Company reports comprehensive income in accordance with FASB ASU 2011-05, "*Presentation of Comprehensive Income*" ("ASU 2011-05") and ASU 2011-12, "*Comprehensive Income (Topic 220)*", and utilizing the option provided by ASU 2011-05 to present the total of comprehensive income, the components of net income and the components of other comprehensive income in a single continuous statement.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*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.

*Presentation*

In order to facilitate the comparison of financial information, certain amounts reported in the prior year have been reclassified to conform to the current year presentation.

**Note 3. New Accounting Pronouncements**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The new standard is effective as of the first interim period within annual reporting periods beginning on or after December 15, 2016, and will replace most existing revenue recognition guidance in U.S. GAAP. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method or determined the effect of the standard

on its financial position, results of operations, cash flows, or presentation thereof.

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**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:

	Net income (loss)	Shares	Per Share Amount
<b><u>Three months ended June 30, 2014:</u></b>			
Basic net income per share:			
Net income applicable to Common Stockholders	\$ 814,475	92,267,831	\$ 0.01
Effect of Dilutive Securities -			
Options	-	1,434,862	0.00
Diluted net income applicable to Common Stockholders	\$ 814,475	93,702,693	\$ 0.01
<b><u>Three months ended June 30, 2013:</u></b>			
Basic net income per share:			
Net income	\$ 1,262,715	24,900,808	\$ 0.05
Series B Preferred Stock liquidation preference increase	(899,220 )	-	(0.04 )
Net income applicable to Common Stockholders	363,495	24,900,808	0.01
Effect of Dilutive Securities -			
Options, Preferred Stock and RSUs	-	2,620,672	-
Diluted net income applicable to Common Stockholders	\$ 363,495	27,521,480	\$ 0.01

## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	Net income (loss)	Shares	Per Share Amount
<b><u>Six months ended June 30, 2014:</u></b>			
Basic net income per share:			
Net income applicable to Common Stockholders	\$ 831,740	92,037,571	\$ 0.01
Effect of Dilutive Securities -			
Options	-	1,529,375	0.00
Diluted net income applicable to Common Stockholders	\$ 831,740	93,566,946	\$ 0.01
<b><u>Six months ended June 30, 2013:</u></b>			
Basic net income per share:			
Net income	\$ 1,543,068	24,652,189	\$ 0.06
Series B Preferred Stock liquidation preference increase	(1,798,441)	-	(0.07 )
Net income (loss) applicable to Common Stockholders	(255,373 )	24,652,189	(0.01 )
Effect of Dilutive Securities -			
Options, Preferred Stock and RSUs	-	-	-
Diluted net income (loss) applicable to Common Stockholders	\$(255,373 )	24,652,189	\$ (0.01 )

For the three months ended June 30, 2014, options to purchase 5,066,667 shares of common stock exercisable between \$0.04 and \$0.20 per share were included in the computation of diluted net income per share. For the six months ended June 30, 2014, options to purchase 5,466,667 shares of common stock exercisable between \$0.04 and \$0.26 per share were included in the computation of diluted net income per share. Options to purchase 1,038,600 and 638,600 shares of common stock for the three and six months ended June 30, 2014 respectively, which are exercisable between \$0.26 and \$5.23 per share, were outstanding but were not included in the computation of diluted net income per share applicable to common stockholders because they would have an antidilutive effect on the net income per share.

For the three months ended June 30, 2013, options to purchase 420,000 shares of common stock exercisable between \$0.04 and \$0.06 per share and RSU's to settle for 7,057,000 common shares were included in the computation of diluted net income per share. For the three months ended June 30, 2013, options to purchase 5,664,600 shares of common stock exercisable between \$0.05 and \$5.23 per share and Series B Preferred Stock convertible into 40,716,000 shares of common stock 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 six months ended June 30, 2013, options to purchase 6,084,600 shares of common stock exercisable between \$0.04 and \$5.23 per share, RSU's to settle for 7,057,000 common shares and Series B Preferred Stock convertible into 40,716,000 shares of common stock were not included in the computation of diluted net income (loss) per share applicable to common shareholders because they would have an antidilutive effect on the net income (loss) per share.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**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 June 30, 2014 and December 31, 2013 was \$27,921 and \$41,596, 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.

Inventories consist of the following:

<b>June 30,</b>	<b>December</b>
<b>2014</b>	<b>31,</b>
	<b>2013</b>



Finished goods	\$895,666	\$1,029,759
Less: Reserves	(244,296)	(229,519 )
Total inventories	\$651,370	\$800,240

**Note 7. Bank Credit Facilities**

On December 31, 2013, the Company entered into a Commercial Credit Agreement (the “Credit Agreement”) with Union Bank, N.A. (“Union Bank”). The Credit Agreement as amended provides for a 24 month revolving loan commitment and a 36 month term loan. The revolving loan commitment includes available borrowings of up to \$3,500,000 (the “Revolving Credit Loan”), consisting of revolving loans and a sublimit of letters of credit not to exceed a maximum aggregate principal amount of \$1,000,000. Borrowings under the Revolving Credit Loan carry interest at a per annum rate of two and one-half percent (2.50%) in excess of a reference rate (“Reference Rate”), which is an index rate determined by Union Bank from time to time as a means of pricing certain extensions of credit. The Reference Rate was 3.25% as of June 30, 2014 and December 31, 2013.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The Credit Agreement also provides for a term loan in the amount of \$5,000,000 (the “Term Loan Payable” and together with the Revolving Credit Loan, the “Credit Facilities”). The Term Loan Payable is payable in 36 monthly payments of \$138,889 beginning January 31, 2014 with interest payable at a per annum rate of two and three-quarters percent (2.75%) in excess of the Reference Rate. The Company paid \$250,000 in financing costs associated with the Credit Agreement. The Company used all of the proceeds of the Term Loan and \$827,490 of the proceeds of the Revolving Credit Loan to repay at December 31, 2013 in full the promissory note entered into in July 2013 with CVC California, LLC (“CVC”) in the principal amount of \$5,800,000 plus accrued interest (See Note 8).

The Credit Agreement contains representations and warranties, affirmative, negative and financial covenants, and events of default, applicable to the Company and its subsidiaries which are customary for Credit Facilities of this type including maintaining a Fixed Charge Coverage Ratio (as defined in the Credit Agreement) of not less than 1.25:1.00 as of the close of each fiscal quarter and an Adjusted EBITDA (as defined in the Credit Agreement) of at least \$2,750,000 as of the close of each fiscal quarter, for the 12-month period ended as of the last day of the quarter.

The payment and performance of all indebtedness and other obligations under the Credit Facilities are secured by liens on substantially all of the Company assets pursuant to the terms and conditions of security agreements and guaranties executed by the Company and its principle operating subsidiaries including Tag-It, Inc., Talon Technologies, Inc., and Tag-It Pacific Limited.

The Company had outstanding borrowings as of June 30, 2014 and December 31, 2013 of \$5,166,667 and \$6,000,000, respectively, under the Credit Facilities, of which \$1,000,000 relates to obligations under the Revolving Credit Loan and the remainder relates to the Term Note Payable. As of June 30, 2014 the Company had \$927,948 in available borrowings.

Interest expense, net included on our Consolidated Statements of Operations is comprised as follows:

	<b>Three Months Ended June 30, 2014</b>	<b>2013</b>	<b>Six Months Ended June 30, 2014</b>	<b>2013</b>
Revolving credit loan	\$ 14,534	\$ -	\$ 30,746	\$ -
Term loan payable	68,400	-	141,088	-
Amortization of deferred financing cost	22,570	-	45,139	-
Total Credit Facilities related interest expense	105,504	-	216,973	-
Other interest expense (income), net	4,110	(197 )	3,912	575
Interest expense (income), net	\$ 109,614	\$ (197 )	\$ 220,885	\$ 575

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 8. Stockholders' Equity**

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

On July 12, 2013 the Company entered into a Securities Redemption Agreement (the "Redemption Agreement") with 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. The 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").

The redemption of the Series B Preferred Stock eliminated the Preferred Stock liquidation preference obligation of \$25,893,686, which had entitled the preferred stockholders 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 that the preferred shares would have become mandatorily redeemable. The redemption resulted in an immediate benefit to common stockholders of \$7,093,686 (less redemption costs of \$154,429). Following the redemption of the Series B Preferred Stock, the Company amended the Corporation's Certificate of Incorporation to eliminate all of the Series B Convertible Preferred Stock. There were no Series B Preferred Stock authorized, issued or outstanding as of June 30, 2014 and December 31, 2013, and the Company now has only common shares outstanding. In connection with the redemption of the Series B Preferred Stock, Mark Hughes, formerly CVC's representative on the Company's Board of Directors, resigned from the Board of Directors effective July 12, 2013. Pursuant to the Redemption Agreement, the existing Stockholder's Agreement with CVC, and with Lonnie D. Schnell (the Company's Chief Executive Officer and a member of the Board of Directors) and Larry Dyne (the Company's President), was terminated.

In order to provide additional funds necessary for the redemption of the Series B Preferred Stock, and simultaneous with the Redemption Agreement, the Company raised \$5,500,000 of new equity through the 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.

In connection with the private placement, the Company entered into a series of Subscription Agreements (the “Subscription Agreements”) and a Registration Rights Agreement (the “Registration Rights Agreement”) with the investors in the transaction. 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 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 then file a registration statement covering the shares issued in the private placement that 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.

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 in settlement of previously vested RSUs pursuant to terms of the 2010 RSU grants and the related deferral elections (See Note 9).

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Authorized Common Stock and Preferred Stock*

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 from 100,000,000 to 300,000,000. The stockholders also 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 when and if the Board of Directors determines that such action is appropriate.

The Company's Certificate of Incorporation presently authorizes the issuance of 3,000,000 shares of Preferred Stock, having a par value of \$0.001 per share. No shares of Preferred Stock were outstanding at June 30, 2014 or December 31, 2013.

*Previously Outstanding Series B Convertible Preferred Stock*

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 Preferred Stock, in payment of an aggregate of \$16,706,685 owed by the Company to CVC at the time under a loan agreement.

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) 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:

The Series B Preferred Stock was not currently redeemable, but it was probable that the preferred stock would become redeemable due to the redemption option available to the preferred stockholders 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. 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. The resulting increases in the carrying amount of the Series B Preferred Stock reduced the income applicable to common stockholders reported in the calculation of earnings per share.

In addition, an annual 16% increase on the liquidation preference of outstanding preferred shares was accrued each reporting period (until the redemption of the outstanding shares of Series B Preferred Stock in July 2013) as an addition to the carrying value of the preferred stock and reduced the income applicable to common stockholders reported in the calculation of earnings per share.

The Series B Preferred Stock was fully redeemed as noted above on July 12, 2013, and the Company subsequently amended the Corporation's Certificate of Incorporation to eliminate all of the authorized Series B Preferred Stock (none of which were outstanding) that had been authorized in 2010 in connection with the Recapitalization Agreement.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Eliminated Series A Preferred Stock*

On July 12, 2013, the Company amended the Corporation's Certificate of Incorporation to eliminate all of the Series A Preferred Stock (none of which were outstanding) which had been authorized in 1998 upon the Company's adoption of a stockholder's rights plan. The stockholder rights plan expired in accordance with its terms in 2008.

*Terminated Stockholders Agreement*

Concurrent 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 and Larry Dyne, that provided for certain voting covenants and rights and restrictions with respect to transfers of stock. The Stockholders Agreement was terminated on July 12, 2013 pursuant to the Redemption Agreement entered into on that date with CVC.

**Note 9. 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.

*Stock Options*



The Company's 2008 Stock Incentive Plan initially authorized the issuance of up to 2,500,000 shares of common stock in awards to individuals under the plan. On November 19, 2010, an amendment to the 2008 Stock Incentive Plan increased the authorized shares from 2,500,000 to 4,810,000. On November 8, 2013, the Company's stockholders approved a further amendment to the 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.

The Company's 2007 Stock Plan was approved by the Company's stockholders in 2007, and replaced the 1997 Stock Plan that had previously authorized the granting of a variety of stock-based incentive awards. 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.

The Board of Directors, who determines the recipients and terms of the awards granted, administers the Company's stock plans. 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 of Directors from immediate to 4 years of continuous service and have 10 year contractual terms.

During the three and six months ended June 30, 2014, 400,000 options were granted. No options were granted during the three and six months ended June 30, 2013.

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

During the six months ended June 30, 2014, options were exercised to acquire 186,458 shares of common stock under the 2007 and 2008 Stock Incentive Plans, and 148,820 shares were retained by the Company in payment of the exercise price of \$0.18 weighted average per share and the tax associated with the exercise of the options. At the time of exercise, the intrinsic value of the options exercised was \$0.27 per share, and the retained shares had a value of \$40,181. During the six months ended June 30, 2014, options were also exercised to acquire 277,084 shares of common stock under the 2008 Stock Incentive Plan. Cash received upon exercise was \$29,709 at a weighted average of \$0.11 per share. At the time of exercise, the intrinsic value of the options exercised was \$0.23 per share. No options were exercised during the three months ended June 30, 2014 and 2013 and six months ended June 30, 2013.

As of June 30, 2014, the Company had \$136,172 of unamortized stock-based compensation expense related to options issued to employees and directors, which will be recognized over the remaining weighted average period of 3.07 years. As of June 30, 2013, unamortized stock-based compensation expense related to options issued to employees and directors was \$45,859, which was to be recognized over the weighted average period of approximately 1.9 years.

The following table summarizes the activity in the Company's share based compensation plans during the six months ended June 30, 2014.

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
<b><i>Employees and Directors</i></b>		
Options outstanding - January 1, 2014	6,221,725	\$ 0.19
Granted	-	\$ -
Exercised	(463,542 )	\$ 0.13
Cancelled	(27,291 )	\$ 0.11
Options outstanding - March 31, 2014	5,730,892	\$ 0.20
Granted	400,000	\$ 0.26
Exercised	-	\$ -

Cancelled	(25,625 )	\$ 0.16
Options outstanding - June 30, 2014	6,105,267	\$ 0.20

***Restricted Stock Units (RSUs)***

On July 30, 2010, the Company awarded each of Lonnie D. 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 RSUs were valued at \$2,263,884, which was reduced by the fair value of the options surrendered by the employees in connection with these grants.

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

On August 30, 2010, Lonnie D. Schnell and Larry Dyne elected to defer the settlement in common shares of 5,434,200 RSUs 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 conditions included in the RSU Awards and the deferral elections.

There were no outstanding RSUs and no unamortized stock-based compensation expense related to RSUs as of June 30, 2014. At December 31, 2013 there were 1,155,700 unvested RSUs with a \$0.196 per share weighted average value per the original award. These RSUs vested and were settled in common stock on January 30, 2014.

Below is a breakdown by date of the common shares issued upon settlement of vested RSU Awards, and the related intrinsic value of the shares issued.

		<b>Common shares issued upon settlement of vested RSUs</b>	<b>Intrinsic value at the time of issuance</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 (1)	-	4,745,600	\$ 0.06
July 30, 2013 (1)	-	1,155,700	\$ 0.25
January 30, 2014 (2)	-	1,155,700	\$ 0.25

Total 11,557,000 11,557,000

On November 7, 2013, the Company redeemed 576,000 shares of common stock at a price of \$0.38 per share.

- (1) The redemption was made in payment of the tax associated with the settlement in July 2013 of previously granted restricted stock units.

On January 30, 2014, 610,894 shares of common stock were issued upon settlement of vested restricted stock

- (2) units, and the equivalent of 544,806 shares were retained by the Company in payment of the tax associated with the vesting of restricted stock units previously granted to the reporting persons.

#### **Note 10. Income taxes**

Provision for income taxes, net for the three and six months ended June 30, 2014 was \$557,475 and \$571,134, respectively. Provision for income taxes, net for the three and six months ended June 30, 2013 was \$326,081 and \$253,833, respectively.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The provision for income taxes in 2014 includes consideration of all taxable income worldwide. In 2013 the provision for income taxes excluded the Company's US and India operations due to valuation reserves against the respective income from these entities. These valuation reserves were removed at December 31, 2013.

The provision for income taxes, net for the six months ended June 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.

Current income taxes receivable were associated with foreign and domestic prepayments and totaled \$17,110 and \$176,935 as of June 30, 2014 and December 31, 2013, respectively.

Current income taxes payable were principally associated with foreign withholdings, funds transfers, and income tax payable from our Asia operations. Current income taxes payable as of June 30, 2014 and December 31, 2013, totaled \$372,950 and \$179,000, respectively, and were included in accrued expenses.

Deferred income tax assets, net totaled \$6,187,181 and \$6,443,385 as of June 30, 2014 and December 31, 2013, respectively, are included in long term deferred income tax assets, net and as part of prepaid expenses and other current assets.

Deferred income tax liabilities totaled \$12,054 and \$30,388 as of June 30, 2014 and December 31, 2013, respectively.

**Note 11. 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:

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 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.

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

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 and accordingly, the Company has not recorded any related liabilities.

**Note 12. Segment Reporting and Geographic Information**

The Company manufactures and distributes a full range of zipper (Talon Zipper), trim (Talon Trim) and waistband, shirt collars and other apparel components utilizing proprietary stretch technology (Talon Tekfit) 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:

	<b>Three Months ended June 30, 2014</b>			
	<b>Talon</b>	<b>Talon</b>	<b>Talon</b>	<b>Talon</b>
	<b>Zipper</b>	<b>Trim</b>	<b>Tekfit</b>	<b>Consolidated</b>
Net sales	\$8,617,171	\$7,324,480	\$17,518	\$ 15,959,169
Cost (recoveries) of goods sold	6,073,050	4,494,881	(14,222)	10,553,709
Gross profit	\$2,544,121	\$2,829,599	\$31,740	5,405,460
Less: Operating expenses				(3,923,896 )



Income from operations

\$ 1,481,564

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Three Months ended June 30, 2013**

	<b>Talon</b>	<b>Talon</b>	<b>Talon</b>	<b>Talon</b>
	<b>Zipper</b>	<b>Trim</b>	<b>Tekfit</b>	<b>Consolidated</b>
Net sales	\$9,501,836	\$7,133,419	\$5,709	\$16,640,964
Cost of goods sold	6,641,230	4,441,343	6,551	11,089,124
Gross profit (loss)	\$2,860,606	\$2,692,076	\$(842 )	5,551,840