

TALON INTERNATIONAL, INC.

Form 10-Q

August 10, 2017

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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, 2017

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 registrant as specified in its charter)

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

**21900 Burbank Boulevard, Suite 270**

**Woodland Hills, California 91367**

(Address of Principal Executive Offices)(Zip Code)

**(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 for 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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if smaller reporting company) Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with the new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

At August 9, 2017, the issuer had **92,338,283** shares of Common Stock, \$.001 par value, issued and outstanding.



**TALON INTERNATIONAL, INC.**

**INDEX TO FORM 10-Q**

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

	<b>June 30, 2017 (Unaudited)</b>	<b>December 31, 2016</b>
Assets		
Current assets:		
Cash and cash equivalents	\$4,671,318	\$4,913,577
Accounts receivable, net	5,887,103	4,315,608
Inventories, net	473,958	500,482
Prepaid expenses and other current assets	783,698	702,906
Total current assets	11,816,077	10,432,573
Property and equipment, net	789,781	884,208
Intangible assets, net	4,260,055	4,266,596
Deferred income tax assets, net	5,040,223	5,224,018
Other assets	407,285	347,638
Total assets	\$22,313,421	\$21,155,033
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portion of revolving line of credit from related party, net	\$39,322	\$-
Current portion of capital lease obligations	24,709	23,749
Accounts payable	7,152,544	6,378,896
Accrued expenses	2,609,865	2,972,689
Total current liabilities	9,826,440	9,375,334
Revolving line of credit from related party, net of current portion, discounts and deferred financing costs	4,055,892	4,041,345
Capital lease obligations, net of current portion	24,436	37,035
Deferred income tax liabilities	1,589	3,037
Other liabilities	220,693	236,088
Total liabilities	14,129,050	13,692,839
Commitments and contingencies (Note 12)		
Stockholders' Equity:		
Common Stock, \$0.001 par value, 300,000,000 shares authorized; 92,338,283 and 92,274,255 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	92,338	92,274
Additional paid-in capital	65,147,086	65,040,432

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Accumulated deficit	(57,134,163)	(57,743,904)
Accumulated other comprehensive income	79,110	73,392
Total stockholders' equity	8,184,371	7,462,194
Total liabilities and stockholders' equity	\$22,313,421	\$21,155,033

See accompanying notes to consolidated financial statements.

## TALON INTERNATIONAL, INC.

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2017	2016	June 30, 2017	2016
Net sales	\$12,885,747	\$14,454,889	\$24,003,281	\$25,719,521
Cost of goods sold	8,115,985	9,003,343	15,145,143	16,103,716
Gross profit	4,769,762	5,451,546	8,858,138	9,615,805
Sales and marketing expenses	1,481,858	1,760,120	3,089,424	3,263,006
General and administrative expenses	2,169,316	1,888,408	4,468,267	4,314,366
Total operating expenses	3,651,174	3,648,528	7,557,691	7,577,372
Income from operations	1,118,588	1,803,018	1,300,447	2,038,433
Interest expense, net	156,742	155,761	310,668	306,408
Income before provision for income taxes	961,846	1,647,257	989,779	1,732,025
Provision for income taxes	357,643	689,559	380,038	725,210
<b>Net income</b>	<b>\$604,203</b>	<b>\$957,698</b>	<b>\$609,741</b>	<b>\$1,006,815</b>
<b>Basic and diluted net income per share</b>	<b>\$0.01</b>	<b>\$0.01</b>	<b>\$0.01</b>	<b>\$0.01</b>
Weighted average number of common shares outstanding - Basic	92,304,510	92,271,078	92,289,466	92,269,455
Weighted average number of common shares outstanding - Diluted	93,015,012	93,474,581	92,949,619	93,486,633
<b>Net income</b>	<b>\$604,203</b>	<b>\$957,698</b>	<b>\$609,741</b>	<b>\$1,006,815</b>
Other comprehensive income (loss) from foreign currency translation	3,776	(11,753)	5,718	(11,456)
<b>Total comprehensive income</b>	<b>\$607,979</b>	<b>\$945,945</b>	<b>\$615,459</b>	<b>\$995,359</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>2017</b>	<b>2016</b>
<i>Cash flows from operating activities:</i>		
Net income	\$609,741	\$1,006,815
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	157,292	148,292
Amortization of deferred financing cost and debt discounts	53,870	52,138
Stock based compensation	106,718	175,512
Deferred income taxes, net	182,347	517,206
Change in provision for bad debt	29,678	(37,823 )
Inventory valuation provisions (recoveries), net	(9,883 )	(12,826 )
Changes in operating assets and liabilities:		
Accounts receivable	(1,576,323)	(962,477 )
Inventories	37,424	29,977
Prepaid expenses and other current assets	(77,561 )	(146,400 )
Other assets	(57,955 )	(55,658 )
Accounts payable and accrued expenses	356,774	1,359,236
Other liabilities	(18,252 )	(46,764 )
Net cash (used in) provided by operating activities	(206,130 )	2,027,228
<i>Cash flows from investing activities:</i>		
Acquisitions of property and equipment	(52,360 )	(242,925 )
Net cash used in investing activities	(52,360 )	(242,925 )
<i>Cash flows from financing activities:</i>		
Payment of capital leases	(11,639 )	(10,754 )
Payments related to taxes on the exercise of stock options	-	(700 )
Net cash used in financing activities	(11,639 )	(11,454 )
Net effect of foreign currency exchange translation on cash	27,870	(41,720 )
Net increase (decrease) in cash and cash equivalents	(242,259 )	1,731,129
Cash and cash equivalents at beginning of period	4,913,577	2,852,315
Cash and cash equivalents at end of period	\$4,671,318	\$4,583,444

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>2017</b>	<b>2016</b>
Cash received (paid) during the period for:		
Interest paid	\$(257,764)	\$(19,599 )
Interest received	\$965	\$914
Income tax paid, net (principally foreign)	\$(46,322 )	\$(35,171 )
Non-cash financing activities:		
Interest accrued on revolving line of credit from related party	\$-	\$235,586
Non-cash exercise of stock options	\$64	\$6

See accompanying notes to consolidated financial statements.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**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, 2016. In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, including normal recurring adjustments, necessary to state fairly the financial position, results of operations, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for 2017.

**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, 2016, 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 the Company's historical experience, for issues not yet identified. Bad debt expense, net for the three and six months ended June 30, 2017 were \$46,981 and \$29,610, respectively. Bad debt recoveries, net for the three and six months ended June 30, 2016 were \$(19,794) and \$(20,046), respectively.

### ***Fair Value Measurements***

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820, "*Fair Value Measurements and Disclosures*" defines fair value 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 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—Include 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**

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, and revolving line of credit from related party. In accordance with ASC 820, the Company measures its cash equivalents at fair value. The Company has determined that the book value of the financial instruments is representative of their fair values. The Company's cash equivalents are classified within Level 1 and valued primarily using quoted market prices utilizing market observable inputs. At June 30, 2017 and December 31, 2016, 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 \$450,334 and \$1,125,000, respectively.

***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 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.

The Company applies Accounting Standards Update ("ASU") 2012-02, "*Intangibles – Goodwill and Other - Testing Indefinite-lived Intangible Assets for Impairment*" to determine whether an impairment is required. The 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 ASC 350-30. The Company completed the required assessment as of December 31, 2016, and noted no impairment. On an ongoing basis, the Company monitors for interim triggering events and noted no triggering events that would result in impairment as of June 30, 2017.

From time to time the Company makes investments in product and technical opportunities that are complimentary to or enhancements to its apparel accessories business. During the three and six months ended June 30, 2017 and 2016, the Company made no investments in property rights. As of June 30, 2017 and December 31, 2016 the Company had accumulated investments of \$38,738 for intellectual property rights complimentary to the Company's Talon Zipper products, which were not yet in service.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Intangible assets as of June 30, 2017 and December 31, 2016 are as follows:

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Tradenname - Talon trademark	\$4,110,751	\$4,110,751
Intellectual property rights	217,459	217,459
Less: Accumulated amortization (10 to 17 years)	(68,155 )	(61,614 )
Intellectual property rights, net	149,304	155,845
Intangible assets, net	\$4,260,055	\$4,266,596

Amortization expense for intangible assets was \$3,271 for each of the three and six months ended June 30, 2017 and 2016, respectively.

***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, amortization of deferred financing costs and amortization of debt discounts. Interest expense for the three and six months ended June 30, 2017 totaled \$157,275 and \$311,633, respectively. Interest expense for the three and six months ended June 30, 2016 totaled \$156,239 and \$307,322, respectively. Interest income consists of earnings from cash held in interest bearing accounts. Interest income for each of the three months ended June 30, 2017 and 2016 was less than \$1,000. Interest income for the six months ended June 30, 2017 and 2016 was \$965 and \$914, respectively.



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***Foreign Currency Translation***

The Company's reporting currency is US dollars. 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 was a cumulative foreign currency translation gain of \$79,110 and \$73,392 as of June 30, 2017 and December 31, 2016, 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 Topic 220 "*Comprehensive Income*", and uses the option provided under ASU 2011-05 "*Presentation of Comprehensive Income*" to present the total of comprehensive income, the components of net income and the components of other comprehensive income in a single continuous statement.

***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, 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.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3. New Accounting Pronouncements**

In May 2017, the FASB issued ASU 2017-09, “Compensation — Stock Compensation (Topic 718): Scope of Modification Accounting.” ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The new guidance is intended to reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if the award’s fair value, vesting conditions and classification as an equity or liability instrument are the same immediately before and after the change. ASU 2017-09 will be applied prospectively to awards modified on or after the adoption date. The guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Management does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-03, “*Accounting Changes and Error Corrections (Topic 250) and Investments – Equity Method and Joint Ventures (Topic 323)*.” This ASU responds to SEC staff announcements made in 2016 as it relates to the disclosure of the future impact of the effects of the new FASB guidance on revenue, leases and credit losses on financial instruments in accordance with Staff Accounting Bulletin 74. This ASU was effective upon issuance in January 2017. Management has adopted ASU 2017-03 effective for the first quarter of 2017. The adoption of ASU 2017-03 did not have a material impact to the Company’s consolidated financial statements.

In December 2016, the FASB issued ASU No. 2016-20, “*Technical Corrections and Improvements (Topic 606): Revenue from Contracts with Customers*.” This ASU provides amendments to ASC 606, “*Revenue from Contracts with Customers*”, allow entities not to make quantitative disclosures about remaining performance obligations in certain cases and require entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. It also makes twelve additional technical corrections and improvements to the new revenue standard. The effective date and transition requirements are the same as those in ASC 606. Management is currently evaluating the impact of this accounting standard on the Company’s consolidated financial statements.

In December 2016, the FASB issued ASU No. 2016-19, “*Technical Corrections and Improvements*”. This ASU clarifies guidance, corrects errors and makes minor improvements affecting a variety of topics in the Accounting Standards Codification. Most of the amendments are not expected to have a significant effect on practice, but some of

them could change practice for some entities. Several provisions in this accounting guidance are effective immediately which did not have an impact on the Company's consolidated financial statements. Additional provisions in this accounting guidance are effective for the Company in annual financial reporting periods beginning after December 15, 2016. Management is currently evaluating the impact that the adoption of the additional provisions in this accounting guidance may have on the Company's consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, "*Income Taxes*" (Topic 740): *Intra-Entity Transfers of Assets Other Than Inventory*." This ASU improves the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual reporting period for which interim or annual financial statements have not been issued. Management is currently evaluating the impact of this accounting standard on the Company's consolidated financial statements.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In August 2016, the FASB issued ASU No. 2016-15, “*Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments.*” This ASU provides amendments to specific statement of cash flows classification issues. The guidance is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. Management is currently evaluating the impact of this accounting standard on the Company’s consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, “*Financial Instruments – Credit Losses*” (Topic 326), which replaces the incurred loss impairment methodology in current generally accepted accounting principles (“GAAP”) with a methodology that reflects expected credit losses. The update is intended to provide financial statement users with more useful information about expected credit losses. The amended guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, with early adoption permitted for the fiscal years, and interim periods within those fiscal years, beginning December 15, 2018. Management is currently evaluating the impact of this accounting standard on the Company’s consolidated financial statements. Management does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “*Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.*” The updated accounting guidance simplifies the accounting for share-based payment award transactions including income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The guidance is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Management has adopted this guidance for the first quarter of 2017. As required by the update, on a prospective basis, the Company will recognize excess tax benefits related to share-based payments in the provision for income taxes in the consolidated statements of income. Also, on a prospective basis, cash flows related to excess tax benefits recognized on stock-based compensation expense will be classified as an operating activity in the Company’s consolidated statements of cash flows. Cash paid on employees’ behalf related to shares withheld for tax purposes continues to be classified as a financing activity. Management elected to continue estimating stock-based compensation award forfeitures in determining the amount of compensation cost to be recognized each period.

In February 2016, the FASB issued ASU No. 2016-02 “*Leases*” (Topic 842). The new standard requires lessee recognition on the balance sheet of a right-of-use asset and a lease liability, initially measured at the present value of the lease payments. It further requires recognition in the income statement of a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis. Finally, it requires classification of

all cash payments within operating activities in the statement of cash flows. It is effective for fiscal years commencing after December 15, 2018 and early adoption is permitted. In accordance with this standard, the Company will be establishing a right-of-use asset and an offsetting lease liability. Once adopted, management expects to report higher assets and liabilities as a result of including additional lease information on the consolidated balance sheet.

In July 2015, the FASB issued ASU 2015-11, "*Simplifying the Measurement of Inventory*", to reduce the complexity in accounting for inventory. This ASU requires entities to measure inventory at the lower of cost and net realizable value, replacing the market value approach that required floor and ceiling considerations. This guidance for public entities is effective for fiscal years beginning after December 15, 2016, with early adoption permitted. Management has adopted this guidance effective for the first quarter of 2017. The adoption of ASU 2015-11 did not have a material impact to the Company's consolidated financial statements.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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 revenue recognition standard provides a five-step analysis of transactions to determine when and how revenue is recognized. The effective date for the ASU 2014-09 is deferred by ASU No. 2015-14, “Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,” to annual reporting periods beginning after December 15, 2017. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The new standard will replace most existing revenue recognition guidance in U.S. GAAP. The standard permits the use of either the retrospective or cumulative effect transition method. Management intends to adopt this standard in the first quarter of 2018 and has not yet selected a transition method. As a result of adoption, management anticipates expanding the consolidated financial statement disclosures in order to comply with the ASU. Management does not expect a material impact on results of operations, cash flows or financial position.

Other pronouncements issued by the FASB or other authoritative accounting standards groups with future effective dates are either not applicable or are not expected to be significant to the Company’s financial position, results of operations or cash flows.

**Note 4. Net Income Per Share**

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

	<b>Net income</b>	<b>Shares</b>	<b>Per Share Amount</b>
<b><u>Three Months Ended June 30, 2017:</u></b>			

Basic net income:

Net income	\$ 604,203	92,304,510	\$ 0.01
Effect of Dilutive Securities - Options	-	710,502	0.00
Diluted net income per share	\$ 604,203	93,015,012	\$ 0.01

**Three Months Ended June 30, 2016:**

Basic net income:

Net income	\$ 957,698	92,271,078	\$ 0.01
Effect of Dilutive Securities - Options	-	1,203,503	0.00
Diluted net income per share	\$ 957,698	93,474,581	\$ 0.01



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Net income	Shares	Per Share Amount
<b><u>Six Months Ended June 30, 2017:</u></b>			
Basic net income:			
Net income	\$ 609,741	92,289,466	\$ 0.01
Effect of Dilutive Securities - Options	-	660,153	0.00
Diluted net income per share	\$ 609,741	92,949,619	\$ 0.01
<b><u>Six Months Ended June 30, 2016:</u></b>			
Basic net income:			
Net income	\$ 1,006,815	92,269,455	\$ 0.01
Effect of Dilutive Securities - Options	-	1,217,178	0.00
Diluted net income per share	\$ 1,006,815	93,486,633	\$ 0.01

For the three months ended June 30, 2017, options to purchase 1,921,667 shares of common stock exercisable between \$0.04 and \$0.11 per share, were outstanding and included in the computation of diluted net income per share. Options to purchase 7,555,000 shares of common stock exercisable between \$0.10 and \$1.33 per share and warrants to purchase 3,250,000 shares of common stock exercisable between \$0.14 and \$0.18 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 six months ended June 30, 2017, options to purchase 1,741,667 shares of common stock exercisable between \$0.04 and \$0.10 per share, were outstanding and included in the computation of diluted net income per share. Options to purchase 7,735,000 shares of common stock exercisable between \$0.10 and \$1.33 per share and warrants to purchase 3,250,000 shares of common stock exercisable between \$0.14 and \$0.18 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 and six months ended June 30, 2016, options to purchase 2,855,000 shares of common stock exercisable between \$0.04 and \$0.11 per share per share, were outstanding and included in the computation of diluted net income per share. Options to purchase 9,488,600 shares of common stock exercisable between \$0.14 and \$1.33 per share and warrants to purchase 3,250,000 shares of common stock exercisable between \$0.14 and \$0.18 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.

**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, 2017 and December 31, 2016 was \$69,977 and \$40,299, respectively.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Inventories**

Inventories are stated at the lower of cost, determined using the first-in, first-out basis, and net realizable 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 net realizable value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Net realizable value of inventory is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation.

Inventories consist of the following:

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Finished goods	\$527,582	\$ 563,989
Less: Reserves	(53,624 )	(63,507 )
Total inventories, net	\$473,958	\$ 500,482

**Note 7. Accrued Expenses**

Accrued expenses are included on the consolidated balance sheets. Accrued expenses consist of the following:

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Accrued payroll and related expenses	\$1,233,776	\$1,532,734
Accrued commissions	328,812	557,369
Accrued rebates	236,215	316,287
Taxes payable	327,669	184,232
Accrued expenses	357,884	268,330
Other	125,509	113,737
Total accrued expenses	\$2,609,865	\$2,972,689

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 8. Credit Facilities, Long Term Obligations and Related Party Transactions**

*Revolving Line of Credit from Related Party*

On August 10, 2015, the Company entered into a loan and reimbursement agreement (“Loan Agreement”) with Princess Investment Holdings Inc. (“Princess Investment”). Princess Investment may be deemed an affiliate of Kutula Holdings, Ltd., a significant stockholder of the Company, which also has the contractual right to designate a director to the Company’s Board of Directors. Pursuant to the Loan Agreement, Princess Investment agreed to make available to the Company a loan of up to \$3,000,000 (“Revolving Line of Credit”) and the Company issued Princess Investment warrants to purchase 1,000,000 shares of the Company’s common stock. The warrants are exercisable immediately upon issuance for a five-year period at an exercise price of \$0.18 per share and include a “cashless” exercise option.

On December 21, 2015, the Company entered into an amended and restated credit agreement (the “Princess Investment Credit Agreement”) with Princess Investment, which amended the existing Loan Agreement, dated August 10, 2015, with Princess Investment to, among other things, increase the borrowing availability under the Loan Agreement from \$3,000,000 to \$6,000,000 and extend the maturity date of the loan to December 21, 2020 (the “Maturity Date”). The Princess Investment Credit Agreement requires the Company to comply with certain financial covenants, including a requirement not to incur a loss after taxes (as calculated in accordance with GAAP) of more than \$1,000,000 in the aggregate for any two consecutive fiscal quarters, not to incur a loss after taxes for any three consecutive fiscal quarters and not to incur a loss after taxes for any trailing twelve month period ending at the end of any fiscal quarter. For the three and six months ended June 30, 2017, the Company was in compliance with all covenants.

Princess Investment will make advances under the Revolving Line of Credit from time to time as requested by the Company. The Company may prepay the Revolving Line of Credit at any time, and amounts prepaid may be re-borrowed through November 21, 2020. Under the amended terms, the Revolving Line of Credit will accrue interest on the unpaid principal balance at an annual rate of 11.5%. Interest on the Revolving Line of Credit for the period from December 21, 2015 through December 1, 2016 accrued and was added to principal on December 1, 2016, and thereafter interest will be payable monthly in arrears. No principal payments will be due during the period ending December 31, 2017. Thereafter, principal will be payable \$25,000 per month during the twelve months ended December 31, 2018, \$35,000 per month during the twelve months ended December 31, 2019 and \$50,000 per month

during the twelve months ended December 31, 2020, with the remaining outstanding principal amount payable on the Maturity Date. The Princess Investment Credit Agreement continues to require payment of a \$60,000 loan fee at maturity.

The payment and performance of all the indebtedness and other obligations to Princess Investment, including all borrowings under the Princess Investment Credit Agreement, are guaranteed by the subsidiaries Talon Technologies, Inc. and Tag-It Pacific Limited pursuant to a Guaranty Agreement entered into on August 10, 2015, as amended on December 21, 2015. The payment and performance of all of the indebtedness and other obligations to Princess Investment under the Princess Investment Credit Agreement and related agreements are secured by liens on substantially all of the Company's assets and the assets of the Company's subsidiary guarantors pursuant to a Pledge and Security Agreement entered into on August 10, 2015, as amended on December 21, 2015.

Pursuant to the Princess Investment Credit Agreement, the Company issued to Princess Investment warrants to purchase 2,000,000 shares of its common stock. The warrants are exercisable immediately upon issuance for a five-year period at an exercise price of \$0.18 per share, and include a "cashless" exercise option.

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

After consideration of FASB ASC 480 “*Distinguishing Liability and Equity*” and ASC 815 “*Derivatives and Hedging*”, the Company concluded that the warrants issued to Princess Investment should be recorded as an equity instrument. The fair value of the first one million warrants of \$130,000 issued with the debt facility at August 10, 2015 and the fair value of the additional two million warrants of \$320,000 issued with this debt facility at December 21, 2015 were valued using the Black-Scholes model. The fair value of the warrants was recorded as additional paid in capital and reflected as a debt discount to the face value of the Revolving Line of Credit, which discount is amortized over the term of the Loan and recognized as additional interest costs as amortized.

At June 30, 2017 and December 31, 2016, respectively, the Company had an outstanding principal balance of approximately \$4,455,643 under the Revolving Line of Credit, and as of June 30, 2017 and December 31, 2016, approximately \$1,544,357 remained in available borrowings under the Revolving Line of Credit.

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
\$6,000,000 revolving line of credit from related party and accrued interest payable per terms under Princess Investment Credit Agreement through maturity date of December 21, 2020; interest at a rate per annum of 11.5%	\$4,455,643	\$4,455,643
Less: Debt discounts net of related amortization	(297,254 )	(342,028 )
Less: Deferred financing costs net of related amortization	(63,175 )	(72,270 )
Revolving line of credit, net of debt discounts and deferred financing costs	4,095,214	4,041,345
Less: Current portion	(150,000 )	-
Revolving line of credit, net of debt discounts, deferred financing costs and current portion	\$3,945,214	\$4,041,345

Interest expense, net, included on the Company’s Consolidated Statements of Income and Comprehensive Income is comprised as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2017</b>	<b>2016</b>	<b>June 30, 2017</b>	<b>2016</b>
Revolving line of credit from related party	\$127,749	\$119,474	\$254,094	\$235,586
Amortization of deferred financing costs	4,548	4,547	9,095	9,095
Amortization of debt discounts	22,912	21,521	44,775	43,043
Total Credit Facilities related interest expense	155,209	145,542	307,964	287,724
Other interest expense, net	1,533	10,219	2,704	18,684
Interest expense, net	\$156,742	\$155,761	\$310,668	\$306,408



**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Capital Leases*

The Company has financed purchases of furniture and fixtures through various capital lease obligations which bear interest at a rate of 8% per annum. Under these obligations, the Company is required to make monthly payments of principal and interest through May 2019.

Capital lease obligations at June 30, 2017 and December 31, 2016 were \$49,144 and \$60,784, respectively.

**Note 9. Stockholders' Equity**

*Authorized Common Stock and Preferred Stock*

The Company's Certificate of Incorporation presently authorizes 300,000,000 shares of Common Stock, having a par value of \$0.001 per share.

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, 2017 or December 31, 2016.

**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 all other non-employee parties are accounted for in accordance with the provisions of FASB ASC 505-50, “*Equity-Based Payments to Non-Employees*”.

### ***Stock Options and Warrants***

The Company’s 2008 Stock Incentive Plan authorizes up to 15,000,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan.

The Company’s 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. No further awards will be granted under the 2007 Stock 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, 2017, 5,000 options were granted. During the three and six months ended June 30, 2016, 120,000 and 4,325,000 options, respectively were granted.

Stock-based compensation expense for the three and six months ended June 30, 2017 totaled \$55,017 and \$106,718, respectively. Stock-based compensation expense for the three and six months ended June 30, 2016 totaled \$63,116 and \$175,512, respectively.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

As of June 30, 2017, the Company had \$419,317 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 2.20 years. As of June 30, 2016, unamortized stock-based compensation expense related to options issued to employees and directors was \$723,640, which was to be recognized over the weighted average period of approximately 3.06 years.

During the three and six months ended June 30, 2017, options were exercised to acquire 64,028 shares of common stock under the 2008 Stock Incentive Plan, and 35,972 shares were retained by the Company in payment of the weighted average exercise price per share of \$0.05. At the time of exercise, the intrinsic value of the options exercised was \$0.14 per share, and the retained shares had a value of \$5,000.

During the three and six months ended June 30, 2016, options were exercised to acquire 6,424 shares of common stock under the 2008 Stock Incentive Plan, and 13,576 shares were retained by the Company in payment of the weighted average exercise price per share of \$0.06 and the tax associated with the exercise of the options. At the time of exercise, the intrinsic value of the options exercised was \$0.14 per share, and the retained shares had a value of \$1,900.

On February 10, 2016, the Company issued warrants to purchase 250,000 shares of the Company's common stock to an outside services company. The warrants are exercisable immediately upon issuance for a five-year period at an exercise price of \$0.14 per share and include a "cashless" exercise provision. The issuance of these securities was exempt from registration pursuant to Section 4(a)(2) of the Securities Act of 1933, as amended.

The following table summarizes the activity in the Company's share-based compensation plans and other share-based grants during the six months ended June 30, 2017.

<b>Number of</b>	<b>Weighted Average</b>
----------------------	-----------------------------

	<b>Shares</b>	<b>Exercise</b>
		<b>Price</b>
<b><i>Employees and Directors</i></b>		
Options outstanding - January 1, 2017	9,933,267	\$ 0.16
Granted	5,000	\$ 0.10
Exercised	(100,000 )	\$ 0.05
Cancelled	(315,000 )	\$ 0.15
Expired	(46,600 )	\$ 1.02
Options outstanding - June 30, 2017	9,476,667	\$ 0.16
<b><i>Non Employees</i></b>		
Warrants outstanding - January 1, 2017	3,250,000	\$ 0.18
Granted	-	\$ -
Exercised	-	\$ -
Cancelled	-	\$ -
Warrants outstanding - June 30, 2017	3,250,000	\$ 0.18

**Note 11. Income taxes**

Provision for income taxes for the three and six months ended June 30, 2017 was \$357,643 and \$380,038, respectively. Provision for income taxes for the three and six months ended June 30, 2016 was \$689,559 and \$725,210, respectively.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Current income taxes receivable were associated with domestic prepayments net of income tax payable, and totaled \$24,448 and \$23,123 as of June 30, 2017 and December 31, 2016, respectively.

Current income taxes payable were principally associated with foreign withholdings, funds transfers, and income tax payable from the Company's Asia operations. Current income taxes payable as of June 30, 2017 and December 31, 2016 totaled \$275,074 and \$120,187, respectively, and were included in accrued expenses.

Deferred income tax assets, net, totaled \$5,040,223 and \$5,224,018 as of June 30, 2017 and December 31, 2016, respectively.

Deferred income tax liabilities totaled \$1,589 and \$3,037 as of June 30, 2017 and December 31, 2016, respectively.

**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:

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.

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 indemnification agreements is minimal and accordingly, the Company has not recorded any related liabilities.

**TALON INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

The Company manufactures and distributes a full range of zipper (“Talon Zipper”) and trim (“Talon Trim”) components, which includes stretch technology component products, to specialty retailers and mass merchandisers. The Company’s organization is based on operating divisions representing these major product lines, and the Company’s Chief Operating Decision Makers (“CODM”, identified as the Company’s executive officers with the oversight of Talon’s Board of Directors) use these divisions to assess performance, allocate resources and make other operating decisions.

During 2015, the Company realigned how it reports its operating segments to better conform to the way management views the business. In making this determination, the Company examined how the CODM evaluates the performance of the Company and as such reconsidered the aggregation of reporting segments in accordance with the aggregation criteria under ASC 280, *Segment Reporting*.

As a result of this assessment, the Company has identified and realigned the reporting of its operating segments into two reporting segments (Talon Zipper and Talon Trim) and has reclassified prior period results to reflect these product categories. The Tekfit operating segment results are now aggregated and reported as part of the Trim operating segment.

Information about the assets for each of the reportable segments is not maintained by the Company and therefore is not reviewed by the CODM as assets are reviewed and assessed on a consolidated basis. As a result, information about the assets for each of the reportable segments is not included on the Company’s segment reporting footnote.

As the Company evolves, adjustments may be made as to how the Company allocates resources and analyzes performance, which can result in a change to these segments.

The net revenues and operating margins for the two reporting segments are as follows:

**Three Months Ended June 30, 2017**

	<b>Talon Zipper</b>	<b>Talon Trim</b>	<b>Talon Consolidated</b>
Net sales	\$5,079,496	\$7,806,251	\$12,885,747
Cost of goods sold	3,591,119	4,524,866	8,115,985
Gross profit	\$1,488,377	\$3,281,385	4,769,762
Operating expenses			3,651,174
Income from operations			\$1,118,588

**Three Months Ended June 30, 2016**

	<b>Talon Zipper</b>	<b>Talon Trim</b>	<b>Talon Consolidated</b>
Net sales	\$6,046,684	\$8,408,205	\$14,454,889
Cost of goods sold	4,197,417	4,805,926	9,003,343
Gross profit	\$1,849,267	\$3,602,279	5,451,546
Operating expenses			3,648,528
Income from operations			\$1,803,018



## TALON INTERNATIONAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Six Months Ended June 30, 2017		
	Talon Zipper	Talon Trim	Talon Consolidated
Net sales	\$8,880,280	\$15,123,001	\$24,003,281
Cost of goods sold	6,391,398	8,753,745	15,145,143
Gross profit	\$2,488,882	\$6,369,256	8,858,138
Operating expenses			7,557,691
Income from operations			\$1,300,447

	Six Months Ended June 30, 2016		
	Talon Zipper	Talon Trim	Talon Consolidated
Net sales	\$10,323,068	\$15,396,453	\$25,719,521
Cost of goods sold	7,213,827	8,889,889	16,103,716
Gross profit	\$3,109,241	\$6,506,564	9,615,805
Operating expenses			7,577,372
Income from operations			\$2,038,433

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 intangibles) is attributed to countries based on the location of the assets, as follows:

<i>Sales:</i> <i>Country / Region</i>	Three Months Ended		Six Months Ended	
	June 30, 2017	2016	June 30, 2017	2016

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United States	\$1,441,475	\$886,992	\$2,522,521	\$1,901,559
China	3,514,032	4,071,603	5,697,415	6,772,717
Hong Kong	1,882,149	3,491,266	4,438,874	6,303,411
Bangladesh	1,043,862	1,379,419	1,963,527	2,428,717
Vietnam	1,111,033	964,002	2,142,516	1,891,934
Indonesia	992,253	641,972	1,928,301	1,120,120
India	699,784	680,268	1,443,342	1,193,872
Other	2,201,159	2,339,367	3,866,785	4,107,191
Total	\$12,885,747	\$14,454,889	\$24,003,281	\$25,719,521

**TALON INTERNATIONAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
<b><i>Long-lived Assets:</i></b>		
United States	\$4,848,197	\$4,915,383
China	143,172	164,081
Hong Kong	54,148	66,347
India	4,319	4,993
Total	\$5,049,836	\$5,150,804

**Note 14. Subsequent Events**

The Company evaluated subsequent events after the balance sheet date of June 30, 2017 through the date of the filing of this report, and determined that there were no reportable subsequent events.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

Talon International, Inc. designs, manufactures, sells and distributes apparel zippers, various apparel trim products and specialty waistbands, shirt collars and other stretch technology and apparel components to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We sell and market these products under various branded names including *Talon*® and *Tekfit*®. As a result, we operate the business globally under two product groups – Talon Zipper and Talon Trim.

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, improve our time-to-market throughout the world by sourcing, finishing and distributing to apparel manufacturers in their local markets.

Our primary business is serving as an outsourced apparel zipper, trim and stretch technology material supplier. We provide product design and development, sampling and sourcing services 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 apparel components other than fabric and thread, 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 at the factory level, in addition to global brands and retailers. 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 stretch technology business provides manufacturers with Talon's patented material stretch technology, manufacturing know-how, proprietary equipment and materials necessary to produce expandable waistbands, shirt collars and various other stretch technology apparel inner lining components. We are actively expanding our marketing and selling efforts of this unique product within the industry, including by introducing this technology to major retailers.

The adoption of new and innovative technology by major retailers, particularly where it modifies the style, design or performance of a garment, is a complicated and time-consuming process. New product innovations by major retailers

can require 6 to 12 months to complete the design, marketing and manufacturing of the new item, and depending upon the seasonal aspect of the garment, introduction of the product to the market could require several additional months. Accordingly, the adoption within the retailers' products of Tekfit technology requires significant time to accomplish. However, once adopted the production volumes continue to build as the technology is accepted across multiple styles with the retailer.

## 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. Sales of our products typically precede the retail sales patterns by approximately 90 to 150 days, with this cycle pattern closer to 75 to 90 days for our more generic products sold to mass merchandisers. The apparel retailers typically experience their highest sales volumes during the fourth quarter in association with year-end holiday purchases. 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. Operating expenses typically follow our seasonal sales patterns fluctuating with the quarterly sales. However our first quarter is typically burdened with higher costs associated with year-end audits, legal reviews, and costs associated with SEC filings, resulting in proportionally higher costs in the first quarter. Because of these fluctuations in our sales and operating costs, results for any quarter are not necessarily indicative of the results that may be achieved for the full year.

## 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</b>		<b>Six Months</b>	
	<b>Ended June 30,</b>		<b>Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	63.0	62.3	63.1	62.6
Gross profit	37.0	37.7	36.9	37.4
Sales and marketing expenses	11.5	12.2	12.9	12.7
General and administrative expenses	16.8	13.1	18.6	16.8
Interest expense, net	1.2	1.0	1.3	1.2
Provision for income taxes	2.8	4.8	1.6	2.8
Net income	4.7 %	6.6 %	2.5 %	3.9 %

*Sales*

For the three and six months ended June 30, 2017 and 2016, sales by geographic region based on the customer delivery locations as a percentage of sales were as follows:

<b>Region</b>	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2017</b>	<b>2016</b>	<b>June 30, 2017</b>	<b>2016</b>
United States	11.2 %	6.1 %	10.5 %	7.4 %
China	27.3	28.2	23.7	26.3
Hong Kong	14.6	24.2	18.5	24.5
Bangladesh	8.1	9.5	8.2	9.4
Vietnam	8.6	6.7	8.9	7.4
Indonesia	7.7	4.4	8.0	4.4
India	5.4	4.7	6.0	4.6
Other	17.1	16.2	16.2	16.0
	100.0%	100.0%	100.0%	100.0%

Sales for the three months ended June 30, 2017 were \$12,886,000 reflecting a decrease of \$1,569,000 or 10.9% as compared to the same period in 2016. Our Talon Zipper products sales for the three months ended June 30, 2017 were \$967,000 lower than the same period in 2016 due to decreased sales of \$417,000 within our mass merchandising brand customers as compared to 2016, and by \$550,000 in sales to our specialty retail brands customers as compared to 2016. Our Talon Trim products sales for the three months ended June 30, 2017 were \$602,000 lower than the same period in 2016 due to decreased sales of \$241,000 within our mass merchandising brand customers as compared to 2016, and by \$361,000 in sales to our specialty retail brands customers as compared to 2016.

Sales for the six months ended June 30, 2017 were \$24,003,000 reflecting a decrease of \$1,717,000 or 6.7% as compared to the same period in 2016. Our Talon Zipper products sales for the six months ended June 30, 2017 were \$1,443,000 lower than the same period in 2016 due to decreased sales of \$517,000 within our mass merchandising brand customers as compared to 2016, and by \$926,000 in sales to our specialty retail brands customers as compared to 2016. Our Talon Trim products sales for the six months ended June 30, 2017 were \$274,000 lower than the same period in 2016 due to decreased sales of \$154,000 within our mass merchandising brand customers as compared to 2016, and by \$119,000 in sales to our specialty retail brands customers as compared to 2016.

*Gross Profit*

Gross profit for the three months ended June 30, 2017 was \$4,770,000 (or 37.0% of sales) as compared to \$5,452,000 (or 37.7% of sales) during the same period in 2016, reflecting a decrease of \$682,000. Gross profit for our Talon Zipper products for the three months ended June 30, 2017 were \$361,000 lower than the same period in 2016 primarily due to lower sales volumes and were partially offset by a favorable change in product mix as well as improved sourcing. For the three months ended June 30, 2017 gross profit attributable to our Talon Trim products decreased \$321,000 due to lower sales volumes, higher manufacturing support costs and was partially offset by a favorable change in product mix.

Gross profit for the six months ended June 30, 2017 was \$8,858,000 (or 36.9% of sales) as compared to \$9,616,000 (or 37.4% of sales) during the same period in 2016, reflecting a decrease of \$758,000. Gross profit for our Talon Zipper products for the six months ended June 30, 2017 were \$620,000 lower than the same period in 2016 primarily due to lower sales volumes and higher manufacturing support costs and was partially offset by a favorable change in product mix as well as improved sourcing. For the six months ended June 30, 2017 gross profit attributable to our Talon Trim products decreased \$138,000 primarily due to higher manufacturing support costs.



A recap of the change in gross profit for the three and six months ended June 30, 2017, as compared to the same period in 2016, is as follows:

	<b>Three Months Ended June 30, 2017 as compared to the same period in 2016</b>		<b>Six Months Ended June 30, 2017 as compared to the same period in 2016</b>	
	<b>\$(1)</b>	<b>% (1)</b>	<b>\$(1)</b>	<b>% (1)</b>
<b>Gross profit changes as a result of:</b>				
Lower sales volumes	(731,000)	(13.4)	(631,000)	(6.6 )
Change in mix of products	130,000	2.4	65,000	0.7
Lower freight and duty costs	4,000	0.1	12,000	0.1
Higher manufacturing overhead costs	(85,000 )	(1.6 )	(204,000)	(2.1 )
Gross profit change	(682,000)	(12.5)	(758,000)	(7.9 )

<sup>(1)</sup> Represents the amount or percentage, as applicable, of change in each item in the three or six month period ended June 30, 2017, as applicable, as compared to the applicable prior year period.

#### *Sales and marketing expenses*

Sales and marketing expenses for the three months ended June 30, 2017 totaled \$1,482,000, a decrease of \$278,000 as compared to the same period in 2016, mainly due to lower sales for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016, as well as \$256,000 in decreased compensation costs as a result of the reorganization of our commission structure and \$48,000 in reduced sample expenses offset by \$37,000 in additional sales administrative costs.

Sales and marketing expenses for the six months ended June 30, 2017 totaled \$3,089,000, a decrease of \$174,000 as compared to the same period in 2016, mainly due to lower sales for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016, as well as \$193,000 in decreased compensation costs as a result of the reorganization of our commission structure and \$42,000 in reduced sample expenses offset by \$52,000 in additional sales administrative costs and \$38,000 in increased travel costs.

*General and administrative expenses*

General and administrative expenses for the three months ended June 30, 2017 totaled \$2,169,000 or 16.8% of sales, as compared to the prior year of \$1,888,000 or 13.1% of sales. General and administrative expenses were higher by \$281,000 during the three months ended June 30, 2017, as compared to the same period in 2016, mainly due to \$122,000 in additional IT support costs as a result of the implementation of a new ERP system and \$100,000 in increased compensation costs resulting from new incentive programs.

General and administrative expenses for the six months ended June 30, 2017 totaled \$4,468,000 or 18.6% of sales, as compared to the prior year of \$4,314,000 or 16.8% of sales. General and administrative expenses were higher by \$154,000 during the six months ended June 30, 2017, as compared to the same period in 2016, mainly due to \$289,000 in additional IT support costs as a result of the implementation of a new ERP system and \$88,000 in increased compensation costs resulting from new incentive programs offset by \$249,000 in reduced professional and legal costs.

*Interest expense and interest income*

Interest expense for the three months ended June 30, 2017, increased by \$1,000 (to \$157,000) as compared to the same period in 2016. Interest expense for the six months ended June 30, 2017, increased by \$5,000 (to \$311,000) as compared to the same period in 2016. Interest expense for the three and six months ended June 30, 2017 and 2016 included borrowings under our credit facility with Princess Investment Holdings, Inc. (the “Princess Investment Credit Facility”) and the related amortization of deferred financing costs and amortization of debt discounts (See Note 8 to the accompanying Notes to Consolidated Financial Statements). A brief summary of interest expense and interest income is presented below:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Amortization of deferred financing costs	\$4,000	\$5,000	\$9,000	\$9,000
Amortization of debt discounts	23,000	22,000	45,000	43,000
Interest expense under Credit Facilities	128,000	118,000	254,000	235,000
Other interest expense	3,000	11,000	4,000	20,000
Interest expense	158,000	156,000	312,000	307,000
Interest income	(1,000 )	-	(1,000 )	(1,000 )
Interest expense, net	\$157,000	\$156,000	\$311,000	\$306,000

*Income taxes*

Provision for income taxes for the three and six months ended June 30, 2017, was \$358,000 and \$380,000, respectively.

Provision for income taxes for the three and six months ended June 30, 2016, was \$689,000 and \$725,000, respectively.

**Liquidity and Capital Resources**

The following table summarizes selected financial data at June 30, 2017 and December 31, 2016:

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Cash and cash equivalents	\$4,671,000	\$4,914,000
Total assets	\$22,313,000	\$21,155,000
Current liabilities	\$9,826,000	\$9,375,000
Long term liabilities	\$4,303,000	\$4,318,000
Stockholders' equity	\$8,184,000	\$7,462,000

We believe that our existing cash and cash equivalents, our anticipated cash flows from our operating activities, and available borrowings from our Princess Investment Credit Facility, will be sufficient to fund our minimum working capital and capital expenditure needs for operating activities for at least the next twelve months. Approximately \$1,544,000 remained in available borrowings under our Princess Investment Credit Facility as of June 30, 2017.

#### *Cash and cash equivalents*

Cash and cash equivalents decreased by \$242,000 at June 30, 2017, as compared to December 31, 2016, principally due to \$206,000 of cash used in operating activities, \$52,000 in payments for the acquisition of property and equipment and \$12,000 in capital lease principal payments.

Cash flow from operations reflects net income from operations excluding non-cash charges, changes in operating capital and the impact of seasonality. During the six months ended June 30, 2017, net cash used in operating activities was \$206,000. During the six months ended June 30, 2016, net cash provided by operating activities was \$2,027,000.

The net cash (used in) provided by operating activities during the six months ended June 30, 2017 and 2016 resulted principally from:

	<b>Six Months Ended June</b>	
	<b>30,</b>	
	<b>2017</b>	<b>2016</b>
Net income before non-cash expenses	\$ 1,130,000	\$ 1,849,000
Accounts receivable increases	(1,576,000)	(962,000 )
Inventory decreases	37,000	30,000
Accounts payable and accrued expenses increases	357,000	1,359,000
Other increases in operating capital	(154,000 )	(249,000 )
Net cash (used in) provided by operating activities	\$(206,000 )	\$ 2,027,000

Net cash used in investing activities for the six months ended June 30, 2017 and 2016 was \$52,000 and \$243,000, respectively, associated mainly with the acquisition of property and equipment.

Net cash used in financing activities for the six months ended June 30, 2017 and 2016 was \$12,000 and \$11,000, respectively, associated with the repayment of borrowings under capital leases.

*Facility with Princess Investment and Capital Leases*

For a description of our credit facility with Princess Investment and our capital lease obligations, see Note 8 of the accompanying notes to consolidated financial statements.

### ***Future Capital Requirements***

We have satisfied our working capital requirements primarily through cash flows generated from operations and borrowings under our Credit Facilities. We continue to evaluate both debt and equity financing options to provide capital to fund our global expansion and on-going operations. The extent of our future long-term capital requirements will depend on many factors, including our results from operations, future demand for our products, the size and timing of possible acquisitions, and our expansion into foreign 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 or reduce the scope of our business in order to fund our on-going operations or to satisfy our future short-term operating requirements. There can be no assurance that additional financing will be available to us when needed or, if available, that it can be obtained on commercially reasonable terms.

### **Off-Balance Sheet Arrangements**

At June 30, 2017 and December 31, 2016, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

### **Related Party Transactions**

See Note 8 of accompanying notes to consolidated financial statements for a discussion of related party transactions.

### **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 their collectibility. 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 allowances for doubtful accounts receivable and the bad debt expense (recoveries), net for the three and six months ended June 30, 2017 and 2016, are as follows:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Allowance for doubtful accounts receivable	\$47,000	\$29,000	\$70,000	\$29,000
Bad debt expense (recoveries), net	\$47,000	\$(20,000)	\$30,000	\$(20,000)

Inventories are stated at the lower of cost, determined using the first-in, first-out ("FIFO") basis, and net realizable 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 net realizable value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Net realizable value of inventory is the estimated selling prices in the ordinary course of business, less reasonable predictable costs of completion, disposal, and transportation. Inventory reserve is reduced following write-off of reserved inventory and increased by additions to reserve for slow moving inventory not expected to be sold.

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 will 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, which have historically been insignificant, are charged against estimated sales return allowances.

Stock-based compensation expense is recognized for all share-based payments to employees, including stock options, in the consolidated statements of income based on the fair value of the awards that are granted. The fair value of stock options is estimated at the date of grant using the Black-Scholes option-pricing model. Measured compensation cost, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period of the related share-based compensation award. See Note 10 in the accompanying Notes to Consolidated Financial Statements.

Impairment charges are recorded when the carrying amount of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy have historically caused us to reassess the carrying amount of Talon's long lived assets. Management completed the required assessment at December 31, 2016 and noted no impairment.

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 Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") No. 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**

See Note 3 of accompanying notes to consolidated financial statements for a discussion of new accounting pronouncements.



**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 Larry Dyne, our principal executive officer, and principal financial officer, and Jamey Johns, 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. Dyne and Mr. Johns 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 June 30, 2017, 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**

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, 2016. No material change to such risk factors has occurred during the three and six months ended June 30, 2017.

**Item 6. Exhibits**

**Exhibit No. Description**

- |           |  |
|-----------|--|
| 31.1**    | Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2**    | Certificate of Chief Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                             |
| 32.1***   | Certificate of Chief Executive Officer and Chief Accounting 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

\*\* Filed herewith.

\*\*\*Furnished herewith.



**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: August 10, 2017 /s/ Larry Dyne

Larry Dyne

Chief Executive Officer and Chief Financial Officer  
(Principal Executive Officer and Principal Financial Officer)

/s/ Jamey Johns

Jamey Johns

Chief Accounting Officer  
(Principal Accounting Officer)