TALON INTERNATIONAL, INC.
Form 10-Q
May 14, 2013

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

FORM 10-Q

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

For the quarterly period ended March 31, 2013.

OR

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

Commission file number 1-13669

TALON INTERNATIONAL, INC.
(Exact Name of Issuer as Specified in its Charter)

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

21900 Burbank Boulevard, Suite 270
Woodland Hills, California 91367
(Address of Principal Executive Offices)

(818) 444-4100
(Registrant's Telephone Number, Including Area Code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for past 90 days. Yes [X] 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 [X] 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 [X] |
|---|---|---|---|

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

At May 13, 2013, the issuer had 24,900,808 shares of Common Stock, $.001 par value, issued and outstanding.

TALON INTERNATIONAL, INC.

INDEX TO FORM 10-Q

TALON INTERNATIONAL, INC.

CONSOLIDATED BALANCE SHEETS

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $7,566,124 | $8,927,333 |
| Accounts receivable, net | 4,063,935 | 3,635,136 |
| Inventories, net | 1,034,339 | 730,503 |
| Prepaid expenses and other current assets | 662,922 | 456,460 |
| Total current assets | 13,327,320 | 13,749,432 |
| | | |
| Property and equipment, net | 709,944 | 763,770 |
| Intangible assets, net | 4,276,923 | 4,279,943 |
| Other assets | 216,273 | 182,671 |
| Total assets | $18,530,460 | $18,975,816 |
| | | |
| Liabilities, Preferred Stock and Stockholders' Equity (Deficit) | | |
| Current liabilities: | | |
| Accounts payable | $7,748,737 | $7,866,662 |
| Accrued expenses | 1,394,276 | 2,023,535 |
| Current portion of capital lease obligations | 2,446 | 3,247 |
| Total current liabilities | 9,145,459 | 9,893,444 |
| | | |
| Deferred income taxes | 981,649 | 945,543 |
| Other liabilities | 48,312 | 186,051 |
| Total liabilities | 10,175,420 | 11,025,038 |
| | | |
| Commitments and contingencies (Note 10) | | |
| | | |
| Series B Convertible Preferred Stock, $0.001 par value; 407,160 shares authorized, issued and outstanding | 24,878,437 | 23,979,216 |
| Stockholders' Equity (Deficit): | | |
| Series A Preferred Stock, $0.001 par value; 250,000 shares authorized; no shares issued or outstanding | - | - |
| Common Stock, $0.01 par value, 100,000,000 shares authorized; 24,900,808 and 23,400,808 shares issued and outstanding at March 31, 2013 and December 31, 2012, respectively | 24,901 | 23,401 |
| Additional paid-in capital | 58,582,431 | 58,458,731 |
| Accumulated deficit | (75,196,920) | (74,578,052) |
| Accumulated other comprehensive income | 66,191 | 67,482 |
| Total stockholders' equity (deficit) | (16,523,397) | (16,028,438) |
| Total liabilities, preferred stock and stockholders' equity (deficit) | $18,530,460 | $18,975,816 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Net sales | $10,139,750 | $8,745,950 |
| Cost of goods sold | 6,963,672 | 5,975,194 |
| Gross profit | 3,176,078 | 2,770,756 |
| | | |
| Sales and marketing expenses | 1,263,992 | 1,096,923 |
| General and administrative expenses | 1,703,209 | 2,147,659 |
| Total operating expenses | 2,967,201 | 3,244,582 |
| | | |
| Income (loss) from operations | 208,877 | (473,826) |
| | | |
| Interest expense, net | 772 | 22,037 |
| Income (loss) before provision for income taxes | 208,105 | (495,863) |
| Benefit from income taxes, net | (72,248) | (290,233) |
| Net income (loss) | $280,353 | $(205,630) |
| | | |
| Series B Preferred Stock Liquidation Preference Increase | (899,221) | (775,190) |
| Loss applicable to Common Shareholders | $(618,868) | $(980,820) |
| | | |
| Per share amounts: | | |
| Net income (loss) per share | $0.01 | $(0.01) |
| Available to Preferred Shareholders | (0.04) | (0.04) |
| Basic and diluted net loss per share applicable to Common Shareholders | $(0.03) | $(0.05) |
| | | |
| Weighted average number of common shares outstanding – Basic and diluted | 24,412,044 | 21,604,105 |
| | | |
| Net income (loss) | $280,353 | $(205,630) |
| Other comprehensive loss - | | |
| Foreign currency translation | (1,291) | (15,634) |
| Total comprehensive income (loss) | $279,062 | $(221,264) |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $280,353 | $(205,630) |
| Adjustments to reconcile net income (loss) to net cash (used in) operating activities: | | |
| Depreciation and amortization | 124,074 | 135,960 |
| (Gain) from disposal of equipment | (1,832) | (27,481) |
| Amortization of deferred financing cost | - | 7,500 |
| Stock based compensation | 125,200 | 134,470 |
| Deferred income taxes, net | 36,106 | (50,464) |
| Bad debt expense (recovery), net | 111 | (658) |
| Inventory valuation provisions, net | 5,994 | (13,780) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (425,927) | 342,972 |
| Inventories | (309,805) | 98,067 |
| Prepaid expenses and other current assets | (205,203) | (292,905) |
| Other assets. | (33,395) | 14,093 |
| Accounts payable and accrued expenses | (756,646) | (817,889) |
| Other liabilities | (137,739) | (195,417) |
| Net cash (used in) operating activities | (1,298,709) | (871,162) |
| | | |
| Cash flows from investing activities: | | |
| Acquisitions of intangibles | - | (142,974) |
| Proceeds from sale of equipment | 1,832 | - |
| Acquisitions of property and equipment | (66,776) | (87,588) |
| Net cash used in investing activities | (64,944) | (230,562) |
| | | |
| Cash flows from financing activities: | | |
| Payment of notes payable to related parties | - | (240,957) |
| Payment of other notes payable | - | (66,675) |
| Payment of capital leases | (801) | (1,420) |
| Net cash (used in) financing activities | (801) | (309,052) |
| | | |
| Net effect of foreign currency exchange translation on cash | 3,245 | (36,430) |
| Net decrease in cash and cash equivalents | (1,361,209) | (1,447,206) |
| Cash and cash equivalents at beginning of period | 8,927,333 | 5,749,341 |
| Cash and cash equivalents at end of period | $7,566,124 | $4,302,135 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

Supplemental disclosures of cash flow information:

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Cash received (paid) during the period for: | | |
| Interest paid | $(1,221) | $(187,393) |
| Interest received | $449 | $384 |
| Income tax paid, net (principally foreign) | $(40,799) | $(162,183) |
| Non-cash financing activities: | | |
| Series B preferred stock liquidation preference increase | $899,221 | $775,190 |
| RSU's settlement in common stock | $1,500 | $900 |
| Interest accrued on notes payable | $- | $1,540 |
| Effect of foreign currency translation on net assets | $(1,291) | $(15,634) |
| Non-cash investing activities: | | |
| Equipment exchanged for manufacturing services | $- | $27,481 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Presentation of Interim Information

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

Note 2. Summary of Significant Accounting Policies

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

Allowance for Accounts Receivable Doubtful Accounts

The Company is required to make judgments as to the collectability of accounts receivable based on established aging policy, historical experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts and that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables to their net realizable value. The Company records these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on our historical experience, for issues not yet identified. Bad debt expense (recovery), net on accounts receivable for the three months ended March 31, 2013 and 2012 was $111 and $(658), 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

The Company’s financial instruments include cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses 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 March 31, 2013 and December 31, 2012, cash equivalents consisted of money market funds measured at fair value on a recurring basis; fair value of the Company’s money market funds was approximately $717,000 and $2,230,000, respectively.

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

Intangible Assets

Intangible assets consist of the Talon trade name acquired in a purchase business combination, patents, licenses, intellectual property rights and technology. Intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually in accordance with the provisions of FASB Accounting Standards Codification (“ASC”) 350, “Intangibles - Goodwill and Other”. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with the provisions of ASC 360, “Property, Plant and Equipment”. Costs incurred to renew or extend the term of recognized intangible assets are capitalized and amortized over the useful life of the asset.

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

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

During the quarter ended March 31, 2012 the Company completed the acquisition from Pro-Fit and related parties of all U.S. patents, applications, trademarks, rights and technology associated with the stretch waistband technology that was formerly exclusively licensed under the License Agreement, and the License Agreement was terminated. During the quarter ended March 31, 2012 the Company also acquired other intellectual property related to accessory components used with a variety of apparel products. The total purchase price and related fees for all intangibles acquired in 2012 totaled $178,722, and is amortized based on the estimated useful lives between 10 and 17 years. Amortization expense for intangible assets was $3,020 for the three months ended March 31, 2013.

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

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Tradename | $ 4,110,751 | $ 4,110,751 |
| Intellectual property rights and exclusive license | 178,722 | 178,722 |
| Accumulated amortization | (12,550) | (9,530) |
| Intellectual property rights, net | 166,172 | 169,192 |
| Intangible assets, net | $ 4,276,923 | $ 4,279,943 |

Convertible Preferred Stock

The Company classifies its conditionally redeemable convertible preferred shares, which are subject to redemption upon the occurrence of uncertain events not solely within our 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.

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

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

9

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

Classification of Expenses

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

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

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

Interest Expense, net – Interest expense reflects the cost of borrowing. Interest expense for the three months ended March 31, 2013 and 2012 totaled $1,221 and $22,421 respectively. Interest income consists of earnings from cash held in interest bearing accounts. For the three months ended March 31, 2013 and 2012 the Company recorded interest income of $449 and $384, 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 $66,191 and $67,482 at March 31, 2013 and December 31, 2012, respectively.

Comprehensive Income (loss)

Comprehensive income (loss) consists of net income (loss) and unrealized income (losses) 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Use of Estimates

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 3. 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 |
|---|---|---|---|
| Three Months ended March 31, 2013: | | | |
| Basic net income (loss) per share: | | | |
| Net income | $280,353 | 24,412,044 | $0.01 |
| Series B Preferred Stock Liquidation Preference Increase | (899,221) | - | (0.04) |
| Income (loss) applicable to Common Shareholders | (618,868) | 24,412,044 | (0.03) |
| | | | |
| Effect of Dilutive Securities - | | | |
| Options, Preferred Stock and RSUs | - | - | - |
| Diluted net income (loss) applicable to Common Shareholders | $(618,868) | 24,412,044 | $$(0.03) |
| | | | |
| Three Months ended March 31, 2012: | | | |
| Basic net income (loss) per share: | | | |
| Net income (loss) | $(205,630) | 21,604,105 | $(0.01) |
| Series B Preferred Stock Liquidation Preference Increase | (775,190) | - | (0.04) |
| Income (loss) applicable to Common Shareholders | (980,820) | 21,604,105 | (0.05) |
| | | | |
| Effect of Dilutive Securities - | | | |
| Options, Preferred Stock and RSUs | - | - | - |
| Diluted net income (loss) applicable to Common Shareholders | $(980,820) | 21,604,105 | $(0.05) |

For the three months ended March 31, 2013, options to purchase 6,372,100 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 to be converted into 40,716,000 shares of common stock were outstanding, but were not included in the computation of diluted net income (loss) per share applicable to common shareholders because they would have an antidilutive effect on the net income (loss) per share.

For the three months ended March 31, 2012, options to purchase 5,942,100 shares of common stock exercisable between $0.06 and $5.23 per share, RSU's to settle for 10,057,000 common shares and Series B Preferred Stock to be converted into 40,716,000 shares of common stock were outstanding, but were not included in the computation of diluted net income (loss) per share because they would have an antidilutive effect on the net income (loss) per share.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 4. Accounts Receivable

Accounts receivable are included on the consolidated balance sheets net of the allowance for doubtful accounts. The allowance for doubtful accounts at March 31, 2013 and December 31, 2012 was $2,510 and $1,093, respectively.

Note 5. 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:

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Finished goods | $ 1,300,824 | $ 991,635 |
| Less reserves | (266,485) | (261,132) |
| Total inventories | $ 1,034,339 | $ 730,503 |

Note 6. Debt Facility

The Company originally entered into a Revolving Credit and Term Loan Agreement (the “Loan Agreement”) on June 27, 2007 with Bluefin Capital, LLC (“Bluefin”). Bluefin subsequently assigned its rights and obligations under the Loan Agreement to an affiliate, CVC California, LLC (“CVC”). On July 30, 2010, the Company entered into a Recapitalization Agreement (the “Recapitalization Agreement”) with CVC in which the Company issued to CVC shares of the Company’s Series B Convertible Preferred Stock in payment of all of the outstanding obligations owed by the Company to CVC under the Loan Agreement, (see Note 7). All of the outstanding obligations owed to CVC under the Loan Agreement that became due and payable on July 30, 2010, in the amount of $16,706,685, were converted into Series B Convertible Preferred Stock pursuant to the Recapitalization Agreement. These obligations consisted of outstanding borrowings and accrued interest of $11,548,098 under term notes, and $5,158,587 under a revolving credit note.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

The interest expense for the three months ended March 31, 2012 was $20,000 composed of $7,500 amortization of deferred financing costs and $12,500 commitment fee expense.

Note 7. Series B Convertible Preferred Stock and Stockholders' Equity (Deficit)

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

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

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

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

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

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

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

The Company determined that there are no embedded features that would require separate reporting as derivative instruments. Therefore, the Company evaluated the conversion option of the convertible preferred shares under FASB ASC No. 470-20, "Debt with Conversion and Other Options", Accounting for Convertible Securities with Beneficial Conversion Features ("BCF") or Contingently Adjustable Conversion Ratios. A convertible financial instrument includes a BCF if the fair value of the instrument is lower than the fair value of shares of the common stock it is convertible into on the issuance date. The BCF shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the conversion feature to additional paid-in capital. The Company has recorded a BCF value of $1,283,343 in connection with the issuance of the Series B Preferred Stock on July 30, 2010.

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

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

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

16

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following table summarizes Series B Preferred Stock activity:

| | |
|---|---|
| Series B Preferred Stock as of December 31, 2012 | $23,979,216 |
| Series B Preferred Stock liquidation preference increase for the three months ended March 31, 2013 | 899,221 |
| Series B Preferred Stock as of March 31, 2013 | $24,878,437 |

Common Stock

Stockholders Agreement

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

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

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

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

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

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

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

Note 8. Stock-Based Compensation

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

Stock Options

The Company’s 2008 Stock Incentive Plan, as amended in November 2010, which was approved by the Company’s stockholders, authorizes up to 4,810,000 shares of common stock that may be issued pursuant to awards granted under the Plan.

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

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

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

No options granted for the three months ended March 31, 2013 and 2012.

As of March 31, 2013, the Company had $68,325 of unamortized stock-based compensation expense related to options issued to employees and directors, which will be recognized over the weighted average period of 1.9 years. As of March 31, 2012, unamortized stock-based compensation expense related to options issued to employees and directors was $102,341, which was to be recognized over the weighted average period of approximately 2.5 years.

The following table summarizes the activity in the Company's share based plans during the three months ended March 31, 2013.

| | Number of Shares | | Weighted Average Exercise Price |
|---|---|---|---|
| Employees and Directors | | | |
| Options outstanding - January 1, 2013 | 6,372,100 | $ | 0.21 |
| Granted | - | $ | - |
| Cancelled | - | $ | - |
| Options outstanding - March 31, 2013 | 6,372,100 | $ | 0.21 |

Restricted Stock Units (RSU's)

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

On August 30, 2010, Messrs. Schnell and Dyne elected to defer the settlement in common shares of 5,434,200 RSU's beyond the vesting dates. On August 30, 2011, based on the deferral schedules, 600,000 common shares were issued upon settlement of a portion of vested units under the RSU Awards. At the time of the issuance the intrinsic value of these shares was $0.10 per share. On January 30, 2012, based on the deferral schedules, 900,000 common shares were issued upon settlement of a portion of vested units under the RSU Awards. At the time of the issuance the intrinsic value of these shares was $0.05 per share. On July 30, 2012 1,500,000 common shares were issued upon settlement of a portion of vested units under the RSU Awards. At the time of the issuance the intrinsic value of these shares was $0.04 per share. On January 30, 2013 1,500,000 common shares were issued upon settlement of a portion of vested units under the RSU Awards. At the time of the issuance the intrinsic value of these shares was $0.04 per share.

As of March 31, 2013, the Company had $377,753 of unamortized stock-based compensation expense related to RSU's, which will be recognized over the remaining weighted average period of 0.8 years.

19

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following table summarizes RSU's activity:

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

Note 9. Income taxes

Benefit from income taxes for the three months ended March 31, 2013 and 2012 was $(72,248) and $(290,233), respectively. The benefit from income taxes, for the three months ended March 31, 2013 included the benefit of the elimination of a tax liability of $135,177 recorded in 2007 in connection with a tax position that could have been subject to reversal upon a regulatory review. At March 31, 2013 the time limit for regulatory assessment of the tax position expired and the liability was removed. The benefit from income taxes for the three months ended March 31, 2012 included the elimination of a tax liability of $196,423 also recorded in 2007, for which the time limit for regulatory review had expired.

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

Other tax liabilities were principally associated with foreign withholdings and funds transfers, and income tax payable from our Hong Kong operation. Other tax liabilities as of March 31, 2013 and December 31, 2012, respectively amounted to $96,103 and $111,235, and were included in Accrued Expenses.

Current income taxes receivable were associated with foreign and domestic prepayments and totaled $180,095 and $178,043, respectively, as of March 31, 2013 and December 31, 2012.

Long term deferred income tax liabilities totaled $981,649 and $945,543 as of March 31, 2013 and December 31, 2012, respectively. The deferred income tax liability is primarily a tax basis difference related to the Company's indefinite lived intangible asset and the balance of a tax liability recorded in 2007 for tax positions subject to regulatory review including accrued penalties and interest.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 10. 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's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws and indemnification agreements is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws and indemnification agreements is minimal and therefore, the Company has not recorded any related liabilities.

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

Note 11. Segment Reporting and Geographic Information

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

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Three Months ended March 31, 2013 | | | |
|---|---|---|---|---|
| | Talon | Trim | Tekfit | Consolidated |
| Net sales | $ 5,800,526 | $ 4,329,944 | $ 9,280 | $ 10,139,750 |
| Cost of goods sold | 4,131,434 | 2,830,150 | 2,088 | 6,963,672 |
| Gross profit | $ 1,669,092 | $ 1,499,794 | $ 7,192 | 3,176,078 |
| Operating expenses | | | | 2,967,201 |
| Income from operations | | | | $ 208,877 |

| | Three Months ended March 31, 2012 | | | |
|---|---|---|---|---|
| | Talon | Trim | Tekfit | Consolidated |
| Net sales | $ 4,456,315 | $ 4,288,684 | $ 951 | $ 8,745,950 |
| Cost of goods sold | 3,203,826 | 2,771,012 | 356 | 5,975,194 |
| Gross profit | $ 1,252,489 | $ 1,517,672 | $ 595 | 2,770,756 |
| Operating expenses | | | | 3,244,582 |
| Loss from operations | | | | $ (473,826 ) |

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

| | Three Months Ended | |
|---|---|---|
| Sales: | March 31, | |
| Country / Region | 2013 | 2012 |
| United States | $ 1,082,087 | $ 901,269 |
| Hong Kong | 3,000,051 | 3,551,624 |
| China | 2,508,776 | 1,574,507 |
| Bangladesh | 637,300 | 444,194 |
| Other | 2,911,536 | 2,274,356 |
| Total | $ 10,139,750 | $ 8,745,950 |

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Long-lived Assets: | | |
| United States | $ 4,551,676 | $ 4,551,101 |
| Hong Kong | 341,674 | 419,268 |
| China | 93,517 | 73,344 |
| Total | $ 4,986,867 | $ 5,043,713 |

Note 12. Subsequent Events

The Company evaluated subsequent events after the balance sheet date of March 31, 2013 through the date of the filing of this report.

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

Overview

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

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

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

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

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

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

Recent Developments

On April 16, 2013 our Board of Directors received an unsolicited proposal from Comvest Capital LLC to acquire all outstanding common stock of Talon at a price of $0.03 per share in cash. Our Board of Directors reviewed and carefully considered the unsolicited proposal with the assistance of its professional advisors, and concluded that the proposal of $0.03 per share of common stock is inadequate and not in the best interests of Talon and its common stockholders. Our Board of Directors has authorized the exploration of strategic alternatives that are in the best interests of its stockholders. The Board intends to consider the full range of available options. There can be no assurance that the exploration of strategic alternatives will result in any transaction, and we do not intend to disclose developments regarding the exploration of strategic alternatives unless and until a transaction has been approved.

Seasonality

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

Results of Operations

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

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| Net sales | 100.0 | % | 100.0 | % |
| Cost of goods sold | 68.7 | | 68.3 | |
| Gross profit | 31.3 | | 31.7 | |
| Sales and marketing expenses | 12.5 | | 12.5 | |
| General and administrative expenses | 16.7 | | 24.6 | |
| Interest expense, net | 0.0 | | 0.3 | |
| Benefit from income taxes, net | (0.7 | ) | (3.3 | ) |
| Net income (loss) | 2.8 | % | (2.4 | )% |

Sales

For the three months ended March 31, 2013 and 2012, sales by geographic region based on the location of the customer as a percentage of sales were as follows:

| Region | Three Months Ended March 31, 2013 | | 2012 | |
|---|---|---|---|---|
| United States | 10.7 | % | 10.3 | % |
| Hong Kong | 29.6 | | 40.6 | |
| China | 24.7 | | 18.0 | |
| Bangladesh | 6.3 | | 5.1 | |
| Other | 28.7 | | 26.0 | |
| | 100.0 | % | 100.0 | % |

Sales for the three months ended March 31, 2013 were $10,140,000, an increase of $1,394,000 or 15.9% compared to the same period in 2012. The increase reflected sales to new specialty apparel customers and new programs within key customer accounts, partially offset by a decline in the sales of generic zippers to price sensitive mass merchandise and licensing customers.

Gross Profit

Gross profit for the three months ended March 31, 2013 was $3,176,000 and 31.3% of sales reflecting an increase of $405,000 as compared to the same period in 2012. The increase in gross profit for the three months ended March 31, 2013 as compared to the same period in 2012 was principally attributable to greater overall sales volumes, partially offset by higher manufacturing support, freight and duty costs.

A recap of the change in gross profit for the three months ended March 31, 2013 as compared with the same period in 2012 is as follows:

| | Three Months Ended March 31, 2013 compared to same period in 2012 $(1) | | %(1) | |
|---|---|---|---|---|
| Gross profit changes as a result of: | | | | |
| Higher sales volumes | 570,000 | | 20.5 | |
| Improved mix of products | 8,000 | | 0.3 | |
| Higher freight and duty costs | (39,000 | ) | (1.4 | ) |
| Higher manufacturing overhead costs | (134,000 | ) | (4.8 | ) |
| Gross profit change | 405,000 | | 14.6 | |

(1) Represents the amount or percentage, as applicable, change in each item in the three months ended March 31, 2013 period, as compared to the same period in 2012.

Sales and marketing expenses

Sales and marketing expenses for the three months ended March 31, 2013 totaled $1,264,000, an increase of $167,000 as compared to same period in 2012. Sales expenses increased mainly due to our continued investment in strengthening our internal sales force in the U.S., Europe and Asia during 2012, and increased sales commissions associated with the higher volumes. The increased sales and marketing efforts are designed to expand our presence in select product markets within the U.S., Europe and Asia where we see significant growth potential.

General and administrative expenses

General and administrative expenses for the three months ended March 31, 2013 totaled $1,703,000, or 16.8% of sales, which was a reduction of $444,000 as compared to the same period in 2012. The reduction resulted mainly from receipt of a settlement of $350,000 associated with a previous legal dispute regarding intellectual property rights, lower non-operational professional fees of $94,000, lower legal fees of $88,000 associated with our efforts to protect trademark filings, and other cost reductions of $24,000, offset by higher net compensation costs of $112,000.

Interest expense and interest income

Interest expense for the three months ended March 31, 2013 and 2012 was $1,000 and $22,000 respectively. Interest income for the three months ended March 31, 2013 and 2012 was less than $1,000.

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

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| Amortization of deferred financing costs | $ | - | $ | 8,000 |
| Other interest expense | | 1,000 | | 14,000 |
| Interest expense | | 1,000 | | 22,000 |
| Interest income | | - | | - |
| Interest expense, net | $ | 1,000 | $ | 22,000 |

Income taxes

Benefit from income taxes, for the three months ended March 31, 2013 and 2012 was $(72,248) and $(290,233), respectively. The benefit from income taxes, for the three months ended March 31, 2013 included the elimination of a tax liability of $135,177, recorded in 2007, for a tax position that could have been subject to reversal upon a regulatory review. At March 31, 2013 the time limit for regulatory assessment of the tax position expired and the liability was removed. The benefit from income taxes for the three months ended March 31, 2012 included the elimination of a tax liability of $196,423 recorded in 2007 for a tax position that could have been subject to reversal upon a regulatory review. At March 31, 2012 the time limit for regulatory assessment of the tax liability had expired and the liability was removed.

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

27

Liquidity and Capital Resources

The following table summarizes selected financial data at:

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Cash and cash equivalents | $ 7,566,000 | $ 8,927,000 |
| Total assets | $ 18,530,000 | $ 18,976,000 |
| Current liabilities | $ 9,145,000 | $ 9,893,000 |
| Long term liabilities | $ 1,030,000 | $ 1,132,000 |
| Preferred stock | $ 24,878,000 | $ 23,979,000 |
| Stockholders' equity (deficit) | $ (16,523,000 ) | $ (16,028,000 ) |
| Total equity and preferred stock | $ 8,355,000 | $ 7,951,000 |

We believe that our existing cash and cash equivalents and our anticipated cash flows from our operating activities will be sufficient to fund our minimum working capital and capital expenditure needs for operating activities for at least the next twelve months.

Cash and cash equivalents

Cash and cash equivalents declined by $1,361,000 at March 31, 2013 as compared to December 31, 2012, principally due to cash used in operating activities of $1,299,000, and the acquisition of property and equipment of $67,000.

Cash provided by operating activities is our primary recurring source of funds, and reflects the net income from operations excluding non-cash charges, and changes in operating capital. The three months ended March 31, 2013 and 2012 reflected net cash used in operating activities of $1,299,000 and $871,000, respectively.

The net cash used in operating activities during the three months ended March 31, 2013 and 2012 resulted principally from:

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Net income (loss) before non-cash expenses | $ 570,000 | $ (20,000 ) |
| Reduced (increased) inventory | (310,000 ) | 98,000 |
| Reduced (increased) accounts receivable | (426,000 ) | 343,000 |
| Reductions in accounts payable and accrued expenses | (757,000 ) | (818,000 ) |
| Other reductions in operating capital | (376,000 ) | (474,000 ) |
| Cash used in operating activities | $ (1,299,000 ) | $ (871,000 ) |

Net cash (used in) investing activities for the three months ended March 31, 2013 and 2012 was $(65,000) and $(231,000), respectively, due to acquisition of intangibles in 2012 of $143,000 and acquisition of property and equipment of $67,000 and $88,000, respectively, offset by proceeds from sale of equipment in amount of $2,000 for the three months ended March 31, 2013.

Net cash (used in) financing activities for the three months ended March 31, 2013 and 2012 was $(1,000) and $(309,000), respectively, reflecting payment of notes payable to related parties and other notes payable in the amount of $241,000 and $67,000, respectively during 2012, and repayment of borrowings under capital leases during 2013 and 2012 of $1,000.

We have financed equipment purchases through capital lease obligations. Our equipment financing obligation as of March 31, 2013 was approximately $3,000 and bore interest at rate of 15.4% per annum. Under these obligations, we are required to make monthly payments of principal and interest through November 2013.

We have satisfied our working capital requirements primarily through cash flows generated from operations and borrowings under our credit facility. As we continue to expand globally with our apparel manufacturing in offshore locations, our customers are substantially all foreign-based and foreign-owned entities. We continue to evaluate both financing and equity options to provide capital if needed to fund our expansion and on-going operations. If we experience greater than anticipated reductions in sales, we may need to borrow or raise additional capital, or further reduce the scope of our business in order to fund our on-going operations or to satisfy our future short-term operating requirements. The extent of our future long-term capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of possible acquisitions, and our expansion into foreign markets. Our need for additional long-term financing may include the integration and expansion of our operations to exploit our rights under our Talon and Tekfit trade names, and the expansion of our operations in the Asian and European markets. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise debt or equity financing in order to provide for our operations.

Contractual Obligations and Off-Balance Sheet Arrangements

The following summarizes our contractual obligations at March 31, 2013:

| | | Payments Due by Period ($) | | | |
|---|---|---|---|---|---|
| Contractual Obligations | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 years |
| Capital lease obligations | $ 3,000 | $ 3,000 | $ - | $ - | $ - |
| Operating leases | 1,065,000 | 524,000 | 540,000 | 1,000 | |
| Total Obligations | $ 1,068,000 | $ 527,000 | $ 540,000 | $ 1,000 | $ - |

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

Related Party Transactions

During the three months ended March 31, 2013, there were no transactions to which we were or will be a party, and in which any director, executive officer, or shareholder of more than 5% of our common stock or any member of their immediate family had or will have a direct or indirect material interest.

Application of Critical Accounting Policies and Estimates

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

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

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

- The net bad debt expense (recovery), net and allowances for the three months ended March 31, 2013 and 2012 are as follows:

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Bad debt expense (recovery), net | $ - | $ (1,000) |
| Allowance for doubtful accounts, Accounts receivable | $ 3,000 | $ 50,000 |

30

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

- We record deferred tax assets and liabilities arising from temporary timing differences between recorded net income and taxable net income when and if we believe that future earnings will be sufficient to realize the tax benefit. For those jurisdictions where the expiration date of tax benefit carry-forwards or the projected taxable earnings indicate that realization is not likely, a valuation allowance is provided. If we determine that we may not realize all of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. A deferred income tax liability related to indefinite lived intangibles should not be offset against deferred income tax assets. We believe that our estimate of deferred tax assets and liabilities and determination to record a valuation allowance against such assets are critical accounting estimates because they are subject to, among other things, an estimate of future taxable income, which is susceptible to change and dependent upon events that may or may not occur, and because the impact of recording a valuation allowance may be material to the assets reported on the balance sheet and results of operations. See Note 9 in the accompanying Notes to Consolidated Financial Statements.

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

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

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

Not Applicable

## Item 4. Controls and Procedures

### Evaluation of Controls and Procedures

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

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

### Changes in Internal Control over Financial Reporting

During the quarter ended March 31, 2013, there were no changes in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II
OTHER INFORMATION

Item 1. Legal Proceedings

On May 7, 2012, we filed a lawsuit against Adidas America, Inc. in the U.S. District Court for the Central District of California asserting claims of trademark infringement, unfair competition, deceptive trade practices and related claims, under both U.S. and California law. The claims arose out of Adidas's use of the "Techfit" name for its apparel, which we asserted infringed our previously registered Tekfit trademark. On May 21, 2012, Adidas then filed a counterclaim against Talon seeking cancellation of our Tekfit U.S. trademark registrations and recovery of legal fees. On January 15, 2013, we received a cash settlement from Adidas and both parties dismissed all related actions with prejudice and ensured that future use of their trademarks would not create confusion to the consumer.

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

Item 1A. Risk Factors

Risk factors are contained in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. No material change to such risk factors has occurred during the three months ended March 31, 2013.

Item 6. Exhibits

| Exhibit No. | Description |
|---|---|
| 10.1 | Form of Indemnification Agreement. |
| 31.1 | Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS* | XBRL Instance |
| 101.SCH* | XBRL Taxonomy Extension Schema |
| 101.CAL* | XBRL Taxonomy Extension Calculation |
| 101.DEF* | XBRL Taxonomy Extension Definition |
| 101.LAB* | XBRL Taxonomy Extension Labels |
| 101.PRE* | XBRL Taxonomy Extension Presentation |

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

SIGNATURES

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

| | |
|---|---|
| Dated: May 14, 2013 | /s/ Lonnie D. Schnell<br>Lonnie D. Schnell<br>Chief Executive Officer and Chief Financial Officer<br>(Principal Executive Officer and Principal Financial Officer) |
| | /s/ James E. Reeder<br>James E. Reeder<br>Vice President, Corporate Controller<br>(Principal Accounting Officer) |