

(Address of Principal Executive Offices)

(818) 444-4100

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or 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, or a smaller reporting company. See the 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 (do not check if smaller reporting company) Smaller reporting company

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

At November 11, 2016, the issuer had 92,274,255 shares of Common Stock, \$.001 par value, issued and outstanding.

TALON INTERNATIONAL, INC.

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

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|--|---|----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$4,190,883 | \$2,852,315 |
| Accounts receivable, net | 3,917,457 | 3,796,209 |
| Inventories, net | 599,792 | 655,360 |
| Current deferred income tax assets, net | 963,432 | 997,067 |
| Prepaid expenses and other current assets | 618,211 | 554,389 |
| Total current assets | 10,289,775 | 8,855,340 |
| Property and equipment, net | 846,120 | 781,893 |
| Intangible assets, net | 4,269,867 | 4,313,948 |
| Deferred income tax assets, net | 4,498,749 | 5,046,345 |
| Other assets | 342,420 | 267,325 |
| Total assets | \$20,246,931 | \$19,264,851 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$5,914,445 | \$6,087,561 |
| Accrued severance payments | 93,333 | 526,671 |
| Accrued commissions | 463,208 | 645,503 |
| Other accrued expenses | 2,075,190 | 1,956,130 |
| Current portion of capital lease obligations | 23,283 | 21,940 |
| Total current liabilities | 8,569,459 | 9,237,805 |
| Revolving line of credit from related party, net of discounts and deferred financing costs | 3,930,861 | 3,492,772 |
| Capital lease obligations, net of current portion | 43,150 | 60,784 |
| Deferred income tax liabilities | 3,413 | 5,406 |
| Other liabilities | 247,440 | 257,903 |
| Total liabilities | 12,794,323 | 13,054,670 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' Equity: | | |
| Common Stock, \$0.001 par value, 300,000,000 shares authorized; 92,274,255 and 92,267,831 shares issued and outstanding at September 30, 2016 and December 31, | 92,274 | 92,268 |

| | | |
|--|--------------|--------------|
| 2015, respectively | | |
| Additional paid-in capital | 64,982,967 | 64,754,306 |
| Accumulated deficit | (57,711,272) | (58,738,782) |
| Accumulated other comprehensive income | 88,639 | 102,389 |
| Total stockholders' equity | 7,452,608 | 6,210,181 |
| Total liabilities and stockholders' equity | \$20,246,931 | \$19,264,851 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------------------|------------------------------------|-------------------|
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | \$ 10,856,283 | \$ 9,992,091 | \$ 36,575,804 | \$ 36,587,791 |
| Cost of goods sold | 7,055,176 | 6,618,550 | 23,158,892 | 24,617,384 |
| Gross profit | 3,801,107 | 3,373,541 | 13,416,912 | 11,970,407 |
| Sales and marketing expenses | 1,706,173 | 1,494,693 | 4,969,179 | 4,778,754 |
| General and administrative expenses | 1,866,292 | 1,715,617 | 6,180,658 | 6,401,400 |
| Total operating expenses | 3,572,465 | 3,210,310 | 11,149,837 | 11,180,154 |
| Income from operations | 228,642 | 163,231 | 2,267,075 | 790,253 |
| Interest expense, net | 157,244 | 127,966 | 463,652 | 328,527 |
| Loss on extinguishment of debt | - | 134,049 | - | 134,049 |
| Income (loss) before provision for income taxes | 71,398 | (98,784) | 1,803,423 | 327,677 |
| Provision for (benefit from) income taxes | 50,703 | (8,431) | 775,913 | 128,746 |
| Net income (loss) | \$ 20,695 | \$ (90,353) | \$ 1,027,510 | \$ 198,931 |
| Basic and diluted net income (loss) per share | \$ 0.00 | \$ 0.00 | \$ 0.01 | \$ 0.00 |
| Weighted average number of common shares outstanding - Basic | 92,274,255 | 92,267,831 | 92,271,066 | 92,267,831 |
| Weighted average number of common shares outstanding - Diluted | 93,220,191 | 92,267,831 | 93,405,895 | 93,519,892 |
| Net income (loss) | \$ 20,695 | \$ (90,353) | \$ 1,027,510 | \$ 198,931 |
| Other comprehensive loss from foreign currency translation | (2,276) | (10,220) | (13,750) | (9,630) |
| Total comprehensive income (loss) | \$ 18,419 | \$ (100,573) | \$ 1,013,760 | \$ 189,301 |

See accompanying notes to consolidated financial statements.

TALON INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2016 | 2015 |
| <i>Cash flows from operating activities:</i> | | |
| Net income | \$ 1,027,510 | \$ 198,931 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 224,360 | 189,309 |
| Loss on extinguishment of debt | - | 134,049 |
| Loss (gain) on disposal of property and equipment | (144) | 281 |
| Amortization of deferred financing cost and debt discounts | 78,206 | 109,117 |
| Stock based compensation | 229,368 | 92,808 |
| Deferred income taxes (benefits), net | 579,237 | (29,590) |
| Change in provision for bad debt | (25,282) | (7,370) |
| Inventory valuation provisions (recoveries), net | (6,846) | 10,882 |
| Adjustment to intangible asset cost | 34,267 | - |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (113,562) | (446,813) |
| Inventories | 60,691 | (69,326) |
| Prepaid expenses and other current assets | (66,500) | (32,923) |
| Other assets. | (76,074) | (97,293) |
| Accounts payable and accrued expenses | (246,845) | 943,966 |
| Other liabilities | (10,296) | 47,670 |
| Net cash provided by operating activities | 1,688,090 | 1,043,698 |
| <i>Cash flows from investing activities:</i> | | |
| Proceeds from sale of equipment | 475 | 350 |
| Acquisitions of property and equipment | (284,700) | (121,393) |
| Acquisitions of intangibles | - | (22,898) |
| Net cash used in investing activities | (284,225) | (143,941) |
| <i>Cash flows from financing activities:</i> | | |
| Revolving line of credit from related party borrowings | - | 2,000,000 |
| Payments of term loan payable | - | (2,833,334) |
| Revolving credit loan borrowings | - | 700,000 |
| Payment of revolving credit loan | - | (600,000) |
| Payment of financing costs associated with credit facilities | - | (138,715) |
| Payment of capital leases | (16,291) | (6,799) |
| Payments related to taxes on the exercise of stock options | (700) | - |
| Net cash used in financing activities | (16,991) | (878,848) |

| | | |
|---|-------------|-------------|
| Net effect of foreign currency exchange translation on cash | (48,306) | (58,421) |
| Net increase (decrease) in cash and cash equivalents | 1,338,568 | (37,512) |
| Cash and cash equivalents at beginning of period | 2,852,315 | 2,603,138 |
| Cash and cash equivalents at end of period | \$4,190,883 | \$2,565,626 |

See accompanying notes to consolidated financial statements.

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

Supplemental disclosures of cash flow information:

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2016 | 2015 |
| Cash received (paid) during the period for: | | |
| Interest paid | \$(27,284) | \$(203,919) |
| Interest received | \$1,720 | \$1,998 |
| Income tax paid, net (principally foreign) | \$76,160 | \$9,858 |
| Non-cash financing activities: | | |
| Warrants issued to related party | \$- | \$119,632 |
| Lease incentives | \$- | \$133,333 |
| Capital lease obligation | \$- | \$94,741 |
| Interest accrued on revolving line of credit from related party | \$359,882 | \$- |
| Non-cash exercise of stock options | \$6 | \$- |
| Effect of foreign currency translation on net assets | \$(13,750) | \$(9,630) |

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, 2015.

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, 2015, 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 nine months ended September 30, 2016 was \$32,047 and \$12,001, respectively. Bad debt expense (recoveries), net for the three and nine months ended September 30, 2015 was \$7,487 and \$(7,370), 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 guidance under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 820, “*Fair Value Measurements and Disclosures*”, establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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

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

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

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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company's financial instruments include cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses, revolving line of credit from related party, capital lease obligations and other liabilities. The book value of the financial instruments is representative of their fair values. In accordance with this guidance, the Company measures its cash equivalents at fair value. The Company's cash equivalents are classified within Level 1. Cash equivalents are valued primarily using quoted market prices utilizing market observable inputs. At September 30, 2016 and December 31, 2015, 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 \$849,000 and \$860,000, 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, 2015, 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 September 30, 2016.

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 nine months ended September 30, 2016, the Company made no investments in property rights. During the three and nine months ended September 30, 2015, the

Company invested \$2,460 and \$22,898 respectively in the acquisition of intellectual property rights complimentary to the Company's Talon Zipper products. As of September 30, 2016 and December 31, 2015 the Company had accumulated investments of \$38,738 and \$73,005, respectively, 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 September 30, 2016 and December 31, 2015 are as follows:

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------------------|----------------------------------|
| Tradenname - Talon trademark | \$4,110,751 | \$4,110,751 |
| Intellectual property rights | 217,459 | 251,727 |
| Less: Accumulated amortization (10 to 17 years) | (58,343) | (48,530) |
| Intellectual property rights, net | 159,116 | 203,197 |
| Intangible assets, net | \$4,269,867 | \$4,313,948 |

Amortization expense for intangible assets was \$3,271 and \$9,813, respectively for the three and nine months ended September 30, 2016 and 2015.

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 nine months ended September 30, 2016 totaled \$158,050 and \$465,372, respectively. Interest expense for the three and nine months ended September 30, 2015 totaled \$128,988 and \$330,525, respectively. Interest income consists of earnings from cash held in interest bearing accounts. Interest income for the three and nine months ended September 30, 2016 totaled \$806 and \$1,720, respectively. Interest income for the three and nine months ended September 30, 2015 totaled \$1,022 and \$1,998, respectively.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 (loss) until the translation adjustments are realized. Included in accumulated other comprehensive income was a cumulative foreign currency translation gain of \$88,639 and \$102,389 as of September 30, 2016 and December 31, 2015, respectively.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) 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 (loss) 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.

Note 3. New Accounting Pronouncements

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.

TALON INTERNATIONAL, INC.

NOTES TO 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

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. 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 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. Management is currently evaluating the impact of this accounting standard on the Company’s consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, “*Balance Sheet Classification of Deferred Taxes*”. This ASU is part of the FASB’s simplification initiative directed at reducing complexity in accounting standards. To simplify presentation, the new guidance requires that all deferred tax assets and liabilities, along with any related valuation allowance, be classified as noncurrent on the balance sheet. As a result, each jurisdiction will now only have one net noncurrent deferred tax asset or liability. The guidance does not change the existing requirement that only permits offsetting within a jurisdiction. For public business entities, the amendments are effective in fiscal years beginning after December 15, 2016, including interim periods within those years. Early adoption is permitted for all entities as of the beginning of an interim or annual reporting period. The guidance may be applied either prospectively, for all deferred tax assets and liabilities, or retrospectively (i.e., reclassifying the comparative balance sheet). Management is currently evaluating the impact of this accounting standard on the Company’s consolidated financial statements, and

expects to adopt this guidance in the fiscal year ending December 31, 2016.

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

In August 2015, the FASB issued ASU 2015-15, “*Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements*”. We previously reported that in April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, which simplifies the presentation of debt issuance costs by requiring that debt issuance costs related to a recognized liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amendments in ASU 2015-15 address the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements such that the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-15 and ASU 2015-03 are effective for financial statements of public business entities issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The Company chose to early adopt the amendment at December 31, 2015. Other than reclassification of debt issuance costs net of amortization from assets to liabilities, no other effect is included on the Company’s consolidated financial statements.

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 or 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. The Company is in the process of evaluating the adoption of this ASU, but does not expect this to have a material effect on its financial position, results of operations or cash flows.

Note 4. Net Income (Loss) Per Share

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

| | Net income (loss) | Shares | Per Share Amount |
|--|----------------------------------|---------------|---------------------------------|
| <u>Three months ended September 30, 2016:</u> | | | |
| Basic net income: | | | |

| | | | |
|--|----------|------------|---------|
| Net income | \$20,695 | 92,274,255 | \$ 0.00 |
| Effect of Dilutive Securities - Options | - | 945,936 | 0.00 |
| Diluted net income per share | \$20,695 | 93,220,191 | \$ 0.00 |

Three months ended September 30, 2015:

| | | | |
|--|------------|------------|------------|
| Basic net loss: | | | |
| Net loss | \$(90,353) | 92,267,831 | \$ 0.00 |
| Effect of Dilutive Securities - Options | - | - | - |
| Diluted net loss per share | \$(90,353) | 92,267,831 | \$ (0.00) |

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| | Net income | Shares | Per Share Amount |
|---|---------------|------------|----------------------------|
| <u>Nine months ended September 30, 2016:</u> | | | |
| Basic net income: | | | |
| Net income | \$ 1,027,510 | 92,271,066 | \$ 0.01 |
| Effect of Dilutive Securities - Options | - | 1,134,829 | 0.00 |
| Diluted net income per share | \$ 1,027,510 | 93,405,895 | \$ 0.01 |
| <u>Nine months ended September 30, 2015:</u> | | | |
| Basic net income: | | | |
| Net income | \$ 198,931 | 92,267,831 | \$ 0.00 |
| Effect of Dilutive Securities - Options | - | 1,252,061 | 0.00 |
| Diluted net income per share | \$ 198,931 | 93,519,892 | \$ 0.00 |

For the three months ended September 30, 2016, options to purchase 2,541,667 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 9,057,600 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 nine months ended September 30, 2016, options to purchase 2,721,667 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 8,877,600 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 months ended September 30, 2015, options to purchase 8,485,287 shares of common stock exercisable between \$0.04 and \$1.33 per share and warrants to purchase 1,000,000 shares of common stock exercisable at \$0.18 per share, were outstanding but were not included in the computation of diluted net loss per share because they would

have an antidilutive effect on the net loss per share.

For the nine months ended September 30, 2015, options to purchase 2,691,667 shares of common stock exercisable between \$0.04 and \$0.11 per share were included in the computation of diluted net income per share, while options to purchase 5,793,600 shares of common stock exercisable between \$0.11 and \$1.33 per share and warrants to purchase 1,000,000 shares of common stock exercisable at \$0.18 per share, were outstanding but were not included in the computation of diluted net income per share because they would have an antidilutive effect on the net income per share.

TALON INTERNATIONAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 5. Accounts Receivable**

Accounts receivable are included on the consolidated balance sheets, net of the allowance for doubtful accounts. The allowance for doubtful accounts at September 30, 2016 and December 31, 2015 was \$41,934 and \$67,217, respectively.

Note 6. Inventories

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

Inventories consist of the following:

| | September 30, 2016 | December 31, 2015 |
|-------------------|-----------------------------------|----------------------------------|
| Finished goods | \$ 661,957 | \$ 724,372 |
| Less: Reserves | (62,165) | (69,012) |
| Total inventories | \$ 599,792 | \$ 655,360 |

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7. 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”). Advances under the Loan Agreement accrued interest initially on the unpaid principal balance at an annual rate of 12.5%. Accrued interest on the Revolving Line of Credit was payable monthly beginning September 1, 2015, and the principal amount was payable in monthly installments beginning September 1, 2016 and continuing through the maturity date of August 10, 2018. Pursuant to the Loan Agreement, 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 August 11, 2015, the Company received an advance from Princess Investment under the Loan Agreement in the amount of \$1,500,000, of which \$1,440,278 was used to pay off the Term Loan Payable to MUFG Union Bank N.A. on August 12, 2015 (See Retired Union Bank Credit Facilities). The Company borrowed an additional \$500,000 through December 21, 2015, and had an outstanding balance of \$2,000,000 under the Revolving Line of Credit from Princess Investment at December 21, 2015.

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 nine months ended September 30, 2016, 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 will accrue and be 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

On December 23, 2015, the Company received an advance from Princess Investment under the Princess Investment Credit Agreement in the amount of \$2,000,000, of which \$1,622,000 was used to pay in full all indebtedness outstanding under the Commercial Credit Agreement, dated December 31, 2013, with MUFG Union Bank N.A., which indebtedness was scheduled to mature on December 31, 2015.

Upon repayment of the indebtedness under the Company's Credit Agreement with Union Bank, Union Bank released its liens on the Company's assets and those of the Company's subsidiaries, Princess Investment became the only secured lender, and in addition to the Credit Agreement, the following agreements (the "Security Agreements") terminated in accordance with their terms: Continuing Guaranties, dated December 31, 2013, executed by the Company's current subsidiaries, Talon Technologies, Inc. and Tag-It Pacific Limited in favor of Union Bank; Security Agreements, dated December 31, 2013, executed by the Company and its current domestic subsidiary, Talon Technologies, Inc., and Union Bank; a Debenture executed by Tag-It Pacific Limited and Union Bank; an Intercreditor Agreement, dated August 10, 2015, among the Company, Princess Investment and Union Bank; and a Subordination Agreement, dated August 10, 2015, among the Company, Princess Investment and Union Bank.

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.

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

At September 30, 2016 and December 31, 2015, the Company had an outstanding principal balance of approximately \$4,371,228 and \$4,011,346, respectively under the Revolving Line of Credit, and as of September 30, 2016 and December 31, 2015, approximately \$1,629,000 and \$2,000,000 remained in available borrowings under the Revolving Line of Credit.

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------------------|----------------------------------|
| \$4,000,000 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% | \$4,371,228 | \$4,011,346 |
| Less: Debt discounts net of related amortization | (363,550) | (428,114) |
| Less: Deferred financing costs net of related amortization | (76,817) | (90,460) |
| Revolving line of credit, net of debt discounts and deferred financing costs | 3,930,861 | 3,492,772 |
| Less: Current portion | - | - |
| Revolving line of credit, net of debt discounts, deferred financing costs and current portion | \$3,930,861 | \$3,492,772 |

Interest expense, net, included on the Company's Consolidated Statements of Operations and Comprehensive Income (Loss) is comprised as follows:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2016 | |
|--|--|-------------|---|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Revolving line of credit from related party | \$124,296 | \$27,397 | \$359,882 | \$27,397 |
| Revolving credit loan | - | 35,841 | - | 96,543 |
| Term loan payable | - | 12,257 | - | 93,280 |
| Amortization of deferred financing costs | 4,547 | 43,021 | 13,642 | 100,935 |
| Amortization of debt discounts | 21,521 | 8,183 | 64,564 | 8,183 |
| Total Credit Facilities related interest expense | 150,364 | 126,699 | 438,088 | 326,338 |
| Other interest expense, net | 6,880 | 1,267 | 25,564 | 2,189 |
| Interest expense, net | \$157,244 | \$127,966 | \$463,652 | \$328,527 |

Retired Union Bank Credit Facilities

On December 31, 2013, the Company entered into a Commercial Credit Agreement (the “Credit Agreement”) with MUFG Union Bank, N.A. (formerly Union Bank, N.A., “Union Bank”). The Credit Agreement initially provided for a 24 month revolving loan commitment and a 36 month term loan. The term loan was extinguished during the quarter ended September 30, 2015 by the payment on August 12, 2015 of \$1,440,278 representing the outstanding principal and interest thereon, and the revolving loan commitment with Union Bank was paid off on December 23, 2015, in each case using proceeds from related party borrowings (See Revolving Line of Credit from Related Party).

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The revolving loan commitment included available borrowings of up to \$3,500,000 (the “Revolving Credit Loan”), consisting of revolving loans and a sublimit of letters of credit not to exceed a maximum aggregate principal amount of \$1,000,000. Borrowings under the Revolving Credit Loan initially carried interest at a per annum rate of two and one-half percent (2.50%) in excess of a reference rate (“Reference Rate”), which is an index rate determined by Union Bank from time to time as a means of pricing certain extensions of credit. The Reference Rate was 3.25% as of December 31, 2014.

The Credit Agreement initially provided for a term loan in the amount of \$5,000,000 (the “Term Loan Payable” and together with the Revolving Credit Loan, the “Union Bank Credit Facilities”). The Term Loan Payable was originally payable in 36 monthly payments of \$138,889 beginning January 31, 2014 with interest payable at a per annum rate of two and three-quarters percent (2.75%) in excess of the Reference Rate. The Credit Agreement contained representations and warranties, affirmative, negative and events of default, applicable to the Company and its subsidiaries which were customary for Union Bank Credit Facilities of this type. The Credit Agreement initially contained financial covenants applicable to the Company and its subsidiaries including maintaining a Fixed Charge Coverage Ratio between Adjusted EBITDA and principal and interest payments (as defined in the Credit Agreement) of not less than 1.25:1.00 as of the close of each fiscal quarter and an EBITDA (as defined in the Credit Agreement) of at least \$2,750,000 as of the close of each fiscal quarter, for the 12-month period ended as of the last day of the quarter. The Company did not satisfy the previous minimum Fixed Charge Coverage Ratio requirement (1.25:1.00) and the previous minimum EBITDA requirement of \$2,750,000 for the 12-month periods ended September 30, 2014 and December 31, 2014, and in connection therewith obtained waivers of such non-compliance from Union Bank for those periods. In exchange for the waivers, the Company paid Union Bank a waiver fee of \$10,000, and at December 31, 2014 a prepayment in the amount of \$500,000 was made and applied to the principal of the Term Loan Payable and certain provisions of the Credit Agreement were amended.

On March 3, 2015, the Credit Agreement was further amended to change various contractual terms as follows: the Fixed Charge Coverage Ratio requirement was reduced for the periods ended March 31, 2015 to 0.70:1.00 and for June 30, 2015 to 1.00:1.00; the minimum EBITDA requirement for the 12-month period ended as of the last day of each of these quarters during 2015 was reduced from \$2,750,000 to \$1,750,000; the requirement of no incurrence of a net loss after taxes for more than two consecutive fiscal quarters was changed to be effective January 1, 2015; net principal repayments totaling \$600,000 in 2015 were added to the Term Loan Payable scheduled payments (\$400,000 were paid during the second quarter of 2015 and the remaining \$200,000 were paid during the third quarter of 2015), and excluded from the Fixed Charge Coverage Ratio calculation; the interest rate on the Term Loan Payable and Revolving Credit Loan was increased by 1% effective March 1, 2015; and the Company paid a loan modification fee of \$50,000, half of which was paid on March 31, 2015 and the other half was paid on June 30, 2015. Additional legal fees were charged by Union Bank during the first quarter of 2015 in the amount of \$6,915. The Company did not satisfy the minimum EBITDA requirement for the 12-month period ended June 30, 2015, due primarily to a \$715,000

one-time accrual for severance payments to Lonnie D. Schnell, the Company's former CEO and board member, that was recognized upon separation during the three months ended June 30, 2015. On August 4, 2015, the Company obtained a waiver from Union Bank of this minimum EBITDA requirement non-compliance and paid Union Bank a waiver fee of \$25,000 as a condition to the waiver.

Prior to repayment, the payment and performance of all indebtedness and other obligations under the Union Bank Credit Facilities were secured by liens on substantially all of the Company assets pursuant to the terms and conditions of security agreements and guaranties executed by the Company and its principle operating subsidiaries including Talon Technologies, Inc. (U.S. operation) and Tag-It Pacific Limited (Hong Kong operation).

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On August 10, 2015, the Company entered into an amendment to the Credit Agreement with Union Bank, which provided for the elimination of financial covenants for the remaining term of the Credit Agreement, permitted the Company to incur \$3,000,000 of subordinated indebtedness, and required the repayment of the outstanding Term Loan Payable in the principal amount of \$1,440,278 plus accrued and unpaid interest by August 31, 2015. In connection with the amendment, the Company incurred approximately \$18,000 in legal fees, representing additional financing costs to the Union Bank Credit Facilities. On August 11, 2015, the Company received an advance from Princess Investment, and on August 12, 2015, the Company paid off \$1,440,278 in outstanding Term Loan Payable from Union Bank as well as the unpaid interest.

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 September 30, 2016 and December 31, 2015 were \$66,433 and \$82,724, respectively.

Note 8. Stockholders' Equity

Authorized Common Stock and Preferred Stock

On November 8, 2013, the Company's stockholders approved an amendment to the Company's Certificate of Incorporation to increase the number of shares of common stock authorized to be issued from 100,000,000 to 300,000,000.

The 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 September 30, 2016 or December 31, 2015.

Note 9. Stock-Based Compensation

The Company accounts for stock-based awards to employees and directors in accordance with FASB ASC 718, "*Compensation - Stock Compensation*", which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. 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 initially authorized the issuance of up to 2,500,000 shares of common stock in awards to individuals under the plan. On November 19, 2010, an amendment to the 2008 Stock Incentive Plan increased the authorized shares from 2,500,000 to 4,810,000. On November 8, 2013, the Company's stockholders approved a further amendment to the 2008 Stock Incentive Plan to increase from 4,810,000 to 15,000,000 the number of shares of common stock that may be issued pursuant to awards under the plan.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company's 2007 Stock Plan was approved by the Company's stockholders in 2007, and replaced the 1997 Stock Plan that had previously authorized the granting of a variety of stock-based incentive awards. The 2007 Stock Plan authorizes up to 2,600,000 shares of common stock for issuance pursuant to awards granted to individuals under the plan. 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 nine months ended September 30, 2016, 200,000 and 4,525,000 options, respectively were granted. During the three and nine months ended September 30, 2015, 300,000 and 700,000 options, respectively were granted.

Stock-based compensation expense for the three and nine months ended September 30, 2016 totaled \$53,854 and \$229,368, respectively. Stock-based compensation expense for the three and nine months ended September 30, 2015 totaled \$36,566 and \$92,808, respectively.

As of September 30, 2016, the Company had \$608,614 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 2.9 years. As of September 30, 2015, unamortized stock-based compensation expense related to options issued to employees and directors was \$410,288, which was to be recognized over the weighted average period of approximately 2.9 years.

During the nine months ended September 30, 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.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the activity in the Company's share-based compensation plans and other share-based grants during the nine months ended September 30, 2016.

| | Number of Shares | Weighted Average Exercise Price |
|---|---------------------|--|
| <i>Employees and Directors</i> | | |
| Options outstanding - January 1, 2016 | 8,435,267 | \$ 0.18 |
| Granted | 4,325,000 | \$ 0.14 |
| Exercised | (20,000) | \$ 0.06 |
| Cancelled | (396,667) | \$ 0.17 |
| Options outstanding – June 30, 2016 | 12,343,600 | \$ 0.17 |
| Granted | 200,000 | \$ 0.10 |
| Exercised | - | \$ - |
| Cancelled | (944,333) | \$ 0.18 |
| Options outstanding – September 30, 2016 | 11,599,267 | \$ 0.17 |
| <i>Non Employees</i> | | |
| Warrants outstanding –January 1, 2016 | 3,000,000 | \$ 0.18 |
| Granted | 250,000 | \$ 0.14 |
| Exercised | - | \$ - |
| Cancelled | - | \$ - |
| Warrants outstanding –June 30, 2016 | 3,250,000 | \$ 0.18 |
| Granted | - | \$ - |
| Exercised | - | \$ - |
| Cancelled | - | \$ - |
| Warrants outstanding – September 30, 2016 | 3,250,000 | \$ 0.18 |

Note 10. Income taxes

Provision for income taxes for the three and nine months ended September 30, 2016 was \$50,703 and \$775,913, respectively. Provision for (benefit from) income taxes, net, for the three and nine months ended September 30, 2015 was \$(8,431) and \$128,746, respectively.

Current income taxes receivable were associated with foreign and domestic prepayments net of income tax payable, and totaled \$10,160 and \$1,953 as of September 30, 2016 and December 31, 2015, 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 September 30, 2016 and December 31, 2015 totaled \$181,144 and \$54,921, respectively, and were included in accrued expenses.

Deferred income tax assets, net, totaled \$5,462,181 and \$6,043,412 as of September 30, 2016 and December 31, 2015, respectively, are included in long term deferred income tax assets, net, and in current deferred income tax assets, net.

Deferred income tax liabilities totaled \$3,413 and \$5,406 as of September 30, 2016 and December 31, 2015, respectively.

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11. Commitments and Contingencies

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

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

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

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.

Note 12. 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.

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

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 September 30, 2016 | | |
|------------------------|--|-----------------------|-------------------------------|
| | Talon Zipper | Talon Trim | Talon Consolidated |
| Net sales | \$3,587,603 | \$7,268,680 | \$10,856,283 |
| Cost of goods sold | 2,670,225 | 4,384,951 | 7,055,176 |
| Gross profit | \$917,378 | \$2,883,729 | 3,801,107 |
| Operating expenses | | | 3,572,465 |
| Income from operations | | | \$228,642 |

**Three Months ended September 30,
2015**

| | Talon Zipper | Talon Trim | Talon Consolidated |
|------------------------|-------------------------|-----------------------|-------------------------------|
| Net sales | \$3,981,191 | \$6,010,900 | \$ 9,992,091 |
| Cost of goods sold | 2,888,204 | 3,730,346 | 6,618,550 |
| Gross profit | \$1,092,987 | \$2,280,554 | 3,373,541 |
| Operating expenses | | | 3,210,310 |
| Income from operations | | | \$ 163,231 |

TALON INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Nine Months ended September 30, 2016

| | Talon Zipper | Talon Trim | Talon Consolidated |
|------------------------|-------------------------|-------------------|-------------------------------|
| Net sales | \$13,910,671 | \$22,665,133 | \$36,575,804 |
| Cost of goods sold | 9,884,052 | 13,274,840 | 23,158,892 |
| Gross profit | \$4,026,619 | \$9,390,293 | 13,416,912 |
| Operating expenses | | | 11,149,837 |
| Income from operations | | | \$2,267,075 |

Nine Months ended September 30, 2015

| | Talon Zipper | Talon Trim | Talon Consolidated |
|------------------------|-------------------------|-------------------|-------------------------------|
| Net sales | \$17,924,116 | \$18,663,675 | \$36,587,791 |
| Cost of goods sold | 13,099,723 | 11,517,661 | 24,617,384 |
| Gross profit | \$4,824,393 | \$7,146,014 | 11,970,407 |
| Operating expenses | | | 11,180,154 |
| Income from operations | | | \$790,253 |

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:

| Sales: <i>Country / Region</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|--------------|
| | 2016 | 2015 | 2016 | 2015 |
| United States | \$1,110,610 | \$738,342 | \$3,012,169 | \$2,411,853 |
| China | 2,945,096 | 2,741,111 | 9,717,813 | 10,235,769 |
| Hong Kong | 2,715,970 | 2,456,406 | 9,019,381 | 7,889,511 |
| Bangladesh | 415,927 | 556,210 | 2,844,644 | 3,033,607 |
| Vietnam | 906,961 | 672,265 | 2,798,895 | 2,320,113 |
| India | 657,862 | 749,785 | 1,851,734 | 2,182,377 |
| Other | 2,103,857 | 2,077,972 | 7,331,168 | 8,514,561 |
| Total | \$10,856,283 | \$9,992,091 | \$36,575,804 | \$36,587,791 |

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

| | September 30, 2016 | December 31, 2015 |
|---------------------------|-----------------------------------|----------------------------------|
| <i>Long-lived Assets:</i> | | |
| United States | \$4,858,567 | \$4,793,042 |
| China | 186,548 | 213,887 |
| Hong Kong | 70,872 | 88,912 |
| Total | \$5,115,987 | \$5,095,841 |

Note 13. Subsequent Events

The Company evaluated subsequent events after the balance sheet date of September 30, 2016 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:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of goods sold | 65.0 | 66.2 | 63.3 | 67.3 |
| Gross profit | 35.0 | 33.8 | 36.7 | 32.7 |
| Sales and marketing expenses | 15.7 | 15.0 | 13.6 | 13.0 |
| General and administrative expenses | 17.2 | 17.2 | 16.9 | 17.5 |
| Interest expense, net | 1.4 | 1.3 | 1.3 | 0.9 |
| Loss on extinguishment of debt | - | 1.3 | - | 0.4 |
| Provision for (benefit from) income taxes | 0.5 | (0.1) | 2.1 | 0.4 |
| Net income (loss) | 0.2 % | -0.9 % | 2.8 % | 0.5 % |

Sales

For the three and nine months ended September 30, 2016 and 2015, sales by geographic region based on the customer delivery locations as a percentage of sales were as follows:

| Region | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------|---|-------------|--|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| United States | 10.2 % | 7.4 % | 8.2 % | 6.6 % |
| China | 27.1 | 27.4 | 26.6 | 28.0 |
| Hong Kong | 25.0 | 24.6 | 24.7 | 21.6 |
| Bangladesh | 3.8 | 5.6 | 7.8 | 8.3 |
| Vietnam | 8.4 | 6.7 | 7.7 | 6.3 |
| India | 6.1 | 7.5 | 5.1 | 6.0 |
| Other | 19.4 | 20.8 | 19.9 | 23.2 |
| | 100.0% | 100.0% | 100.0% | 100.0% |

Sales for the three months ended September 30, 2016 were \$10,856,000 reflecting an increase of \$864,000 or 8.6% as compared to the same period in 2015. Our Talon Zipper products sales for the three months ended September 30, 2016 were \$394,000 lower than the same period in 2015 due to decreases in sales from our specialty retail brands customers of \$396,000, as compared to 2015. For the three months ended September 30, 2016, sales of Talon Trim products, which consist primarily of sales to specialty retail branded customers, increased by \$1,258,000 compared to the same period in 2015, mainly due to new stretch technology programs and customers.

Sales for the nine months ended September 30, 2016 were \$36,576,000, reflecting a decline of \$12,000 as compared to the same period in 2015. Our Talon Zipper products sales for the nine months ended September 30, 2016 were \$4,013,000 lower than the same period in 2015. Talon Zipper products sales for the nine months ended September 30, 2016 decreased by \$1,125,000 within our mass merchandising brand customers as compared to 2015, and by \$2,888,000 in sales to our specialty retail brands customers as compared to 2015. For the nine months ended September 30, 2016, Talon Trim products sales increased by \$4,001,000 compared to the same period in 2015, mainly due to new stretch technology programs and customers.

Gross Profit

Gross profit for the three months ended September 30, 2016 was \$3,801,000 (or 35.0% of sales) as compared to \$3,374,000 (or 33.8% of sales) during the same period in 2015, reflecting an increase of \$427,000, principally

attributable to a higher sales volumes for Talon Trim products, and a greater mix of higher-margin products in the Talon Zipper and the Talon Trim products, offset by higher freight, duty and manufacturing support costs and lower overall sales volumes for Talon Zipper products.

Gross profit for the nine months ended September 30, 2016 was \$13,417,000 (or 36.7% of sales), reflecting an increase of \$1,447,000 as compared to the same period in 2015. The increase in gross profit for the nine months ended September 30, 2016, as compared to prior year, was principally attributable to a greater mix of higher-margin products in the Talon Zipper and the Talon Trim products, as well as higher sales volumes for Talon Trim products, and lower freight and duty, offset by lower overall sales volume for Talon Zipper products and higher manufacturing overhead costs.

A recap of the change in gross profit for the three and nine months ended September 30, 2016, as compared to the same period in 2015, is as follows:

| | Three Months Ended 9/30/2016 as compared to the | | Nine Months Ended 9/30/2016 as compared to the | |
|---|--|--------------|---|--------------|
| | same period in 2015 \$(1) | % (1) | same period in 2015 \$(1) | % (1) |
| Gross profit changes as a result of: | | | | |
| Higher sales volumes | 456,000 | 13.5 | 332,000 | 2.8 |
| Change in mix of products | 201,000 | 6.0 | 895,000 | 7.5 |
| Lower (higher) freight and duty costs | (30,000) | (0.9) | 335,000 | 2.8 |
| Lower (higher) manufacturing overhead costs | (200,000) | (5.9) | (115,000) | (1.0) |
| Gross profit change | 427,000 | 12.7 | 1,447,000 | 12.1 |

(1) Represents the amount or percentage, as applicable, of change in each item in the three or nine month period ended September 30, 2016, as applicable, as compared to the applicable prior year period.

Sales and marketing expenses

Sales and marketing expenses for the three months ended September 30, 2016 totaled \$1,706,000, an increase of \$211,000 as compared to the same period in 2015, mainly due to \$93,000 in additional compensation costs, \$93,000 in additional marketing and new product development costs, \$23,000 in increased travel and entertainment expenses and \$20,000 in increased facilities and related expenses offset by \$18,000 in reduced administrative costs.

Sales and marketing expenses for the nine months ended September 30, 2016 totaled \$4,969,000, an increase of \$190,000 as compared to the same period in 2015, mainly due to \$115,000 in additional compensation costs, \$61,000 in increased facilities and related expenses, \$45,000 in increased marketing expense and new product development costs and \$16,000 in additional administrative costs, offset by \$47,000 in reduced travel and entertainment expenses.

General and administrative expenses

General and administrative expenses for the three months ended September 30, 2016 totaled \$1,866,000 or 17.2% of sales, as compared to the prior year of \$1,716,000 or 17.2% of sales. General and administrative expenses were higher by \$151,000 during the three months ended September 30, 2016, as compared to the same period in 2015, mainly due to \$205,000 in additional compensation costs and \$20,000 in additional travel and entertainment expenses, offset by \$125,000 in reduced professional, legal and administrative costs.

In September 2016, we recovered \$250,000 of funds previously transferred to an overseas account as a result of a fraud known to law enforcement authorities as business e-mail compromise fraud, which involved employee impersonation and fraudulent requests targeting our finance department. As a result, we recorded a benefit of \$250,000 in the third quarter of 2016. The fraud was previously charged as a loss in the fourth quarter of 2015.

General and administrative expenses for the nine months ended September 30, 2016 totaled \$6,181,000 or 16.9% as a percentage of sales, as compared to general and administrative expenses in the prior year of \$6,401,000 or 17.5% as a percentage of sales. General and administrative expenses were lower by \$221,000 during the nine months ended September 30, 2016, as compared to the same period in 2015, mainly due to \$409,000 in decreased compensation costs and \$184,000 in reduced general and administrative costs, primarily the result of the fraud recovery, offset by \$203,000 in increased professional, legal and administrative costs, \$85,000 in increased travel and entertainment expenses and \$34,000 in additional facilities and related expenses.

Interest expense and interest income

Interest expense for the three months ended September 30, 2016, increased by \$29,000 (to \$157,000) as compared to the same period in 2015. Interest expense for the nine months ended September 30, 2016, increased by \$135,000 (to \$464,000) as compared to the same period in 2015. Interest expense for the three and nine months ended September 30, 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 7 to the accompanying Notes to Consolidated Financial Statements). Interest expense for the three and nine months ended September 30, 2015 included borrowings under our Credit Facilities with MUFG Union Bank, N.A., which were terminated on December 23, 2015 (formerly Union Bank, N.A., “Union Bank”). A brief summary of interest expense and interest income is presented below:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Amortization of deferred financing costs | \$5,000 | \$43,000 | \$14,000 | \$101,000 |
| Amortization of debt discounts | 22,000 | 8,000 | 65,000 | 8,000 |
| Interest expense under Credit Facilities | 123,000 | 76,000 | 360,000 | 218,000 |
| Other interest expense | 8,000 | 2,000 | 27,000 | 4,000 |
| Interest expense | 158,000 | 129,000 | 466,000 | 331,000 |
| Interest income | (1,000) | (1,000) | (2,000) | (2,000) |
| Interest expense, net | \$157,000 | \$128,000 | \$464,000 | \$329,000 |

Loss on extinguishment of debt

Loss on extinguishment of debt in the amount of \$134,000 was recorded during the three and nine months ended September 30, 2015 as a result of paying off the Term Note Payable to Union Bank. See Note 7 in the accompanying Notes to Consolidated Financial Statements.

Income taxes

Provision for income taxes for the three and nine months ended September 30, 2016, was \$51,000 and \$776,000, respectively.

Provision for (benefit from) income taxes, net, for the three and nine months ended September 30, 2015, was \$(8,000) and \$129,000, respectively.

Liquidity and Capital Resources

The following table summarizes selected financial data at September 30, 2016 and December 31, 2015:

| | June 30, 2016 | December 31, 2015 |
|---------------------------|--------------------------|----------------------------------|
| Cash and cash equivalents | \$4,191,000 | \$2,852,000 |
| Total assets | \$20,247,000 | \$19,265,000 |
| Current liabilities | \$8,569,000 | \$9,238,000 |
| Long term liabilities | \$4,225,000 | \$3,817,000 |
| Stockholders' equity | \$7,453,000 | \$6,210,000 |

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 \$1,629,000 remained in available borrowings under our Princess Investment Credit Facility as of September 30, 2016.

Cash and cash equivalents

Cash and cash equivalents increased by \$1,339,000 at September 30, 2016, as compared to December 31, 2015, principally due to \$1,688,000 of cash provided by operating activities, offset by \$285,000 in payments for the acquisition of property and equipment and \$16,000 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 nine months ended September 30, 2016 and 2015, net cash provided by operating activities was \$1,688,000 and \$1,044,000, respectively.

The net cash provided by operating activities during the nine months ended September 30, 2016 and 2015 resulted principally from:

Nine Months Ended September 30,

| | 2016 | | 2015 | |
|--|--------------|---|--------------|---|
| Net income before non-cash expenses | \$ 2,141,000 | | \$ 698,000 | |
| Inventory reductions (increases) | 61,000 | | (69,000 |) |
| Accounts receivable increases | (114,000 |) | (447,000 |) |
| Accounts payable and accrued expenses increases (reductions) | (247,000 |) | 944,000 | |
| Other increases in operating capital | (153,000 |) | (82,000 |) |
| Net cash provided by operating activities | \$ 1,688,000 | | \$ 1,044,000 | |

Net cash used in investing activities for the nine months ended September 30, 2016 and 2015 was \$284,000 and \$144,000, respectively, associated mainly with the acquisition of property and equipment, and for 2015 included \$23,000 in the acquisition of intellectual property rights.

Net cash used in financing activities for the nine months ended September 30, 2016 and 2015 was \$17,000 and \$879,000, respectively. In 2016, this reflects \$16,000 in capital lease principal payments. In 2015 this reflects \$2,833,000 in term loan payments, \$600,000 in repayments of Revolving Credit Loan borrowings, \$139,000 in payments of financing costs associated with credit facilities and \$7,000 in repayment of borrowings under capital leases, offset by \$2,000,000 Revolving Term Loan from related party borrowings, and \$700,000 in Revolving Credit Loan borrowings under our Union Bank Credit Facilities.

Facility with Princess Investment, Terminated Facility with Union Bank and Capital Leases

For a description of our credit facility with Princess Investment, our terminated credit facilities with Union Bank and our capital lease obligations, see Note 7 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.

Contractual Obligations

The following summarizes our contractual obligations at September 30, 2016:

| Contractual Obligations | Payments Due by Period (\$) | | | |
|--|------------------------------------|-----------------------------|----------------------|----------------------|
| | Total | Less than 1 Year | 1-3 Years | 4-5 Years |
| Revolving line of credit from related party | \$6,353,000 | \$427,000 | \$2,557,000 | \$3,369,000 |
| Operating leases | 2,345,000 | 928,000 | 1,398,000 | 19,000 |
| Capital leases | 74,000 | 28,000 | 46,000 | - |
| Software as a Service "SaaS" license agreement | 1,374,000 | 555,000 | 614,000 | 205,000 |
| Total Obligations | \$10,146,000 | \$1,938,000 | \$4,615,000 | \$3,593,000 |

Off-Balance Sheet Arrangements

At September 30, 2016 and December 31, 2015, 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 7 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 as at and for the three and nine months ended September 30, 2016 and 2015, are as follows:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2015 | |
|--|--|----------|---|-----------|
| Allowance for doubtful accounts receivable | \$42,000 | \$40,000 | \$42,000 | \$40,000 |
| Bad debt expense (recoveries), net | \$32,000 | \$7,000 | \$12,000 | \$(7,000) |

Inventories are stated at the lower of cost, determined using the first-in, first-out (“FIFO”) basis, or market value and are all substantially finished goods. The costs of inventory include the purchase price, inbound freight and duties, conversion costs and certain allocated production overhead costs. Inventory is evaluated on a continual basis and reserve adjustments are made based on management’s estimate of future sales value, if any, of specific inventory items. Inventory reserves are recorded for damaged, obsolete, excess, impaired and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to these adjustments become known. Market value of inventory is estimated based on the impact of market trends, an evaluation of economic conditions and the value of current orders relating to the future sales of this type of inventory. Inventory reserve is reduced following 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 10 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.

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 September 30, 2016, 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, 2015. No material change to such risk factors has occurred during the three and nine months ended September 30, 2016.

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: November 14, 2016

/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)