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TARRANT APPAREL GROUP

Form 10-Q

November 14, 2005

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934. FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER: 0-26006

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TARRANT APPAREL GROUP  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

CALIFORNIA  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

95-4181026  
(I.R.S. EMPLOYER  
IDENTIFICATION NUMBER)

3151 EAST WASHINGTON BOULEVARD  
LOS ANGELES, CALIFORNIA 90023  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) (ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (323) 780-8250

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 the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

Number of shares of Common Stock of the registrant outstanding as of November 10, 2005: 30,553,763.

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### CAUTIONARY LEGEND REGARDING FORWARD-LOOKING STATEMENTS

Some of the information in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. These forward-looking statements are subject to various risks and uncertainties. The forward-looking statements include, without limitation, statements regarding our future business plans and strategies and our future financial position or results of operations, as well as other statements that are not historical. You can find many of these statements by looking for words like "will", "may", "believes", "expects", "anticipates", "plans" and "estimates" and for similar expressions. Because forward-looking statements involve risks and uncertainties, there are many factors that could cause the actual results to differ materially from those expressed or implied. These include, but are not limited to, economic conditions. This Quarterly Report on Form 10-Q contains important cautionary statements and a discussion of many of the factors that could materially affect the accuracy of Tarrant's

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forward-looking statements and such statements and discussions are incorporated herein by reference. Any subsequent written or oral forward-looking statements made by us or any person acting on our behalf are qualified in their entirety by the cautionary statements and factors contained or referred to in this section. We do not intend or undertake any obligation to update any forward-looking statements to reflect events or circumstances after the date of this document or the date on which any subsequent forward-looking statement is made or to reflect the occurrence of unanticipated events.

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## PART I -- FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS.

#### TARRANT APPAREL GROUP CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
	----- (Unaudited)	----- (Audited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 1,636,941	\$ 1,214,944
Accounts receivable, net .....	64,859,916	37,759,343
Due from related parties .....	3,794,229	10,651,914
Inventory .....	26,364,421	19,144,105
Current portion of notes receivable from related parties	5,323,733	5,323,733
Prepaid expenses .....	1,292,308	1,251,684
Prepaid royalties .....	2,162,450	2,257,985
Income taxes receivable .....	145,236	144,796
	-----	-----
Total current assets .....	105,579,234	77,748,504
Property and equipment, net .....	1,745,910	1,874,893
Notes receivable - related party, net of current portion	38,728,558	40,107,337
Due from related parties .....	2,796,516	--
Equity method investment .....	2,140,228	1,880,281
Deferred financing cost, net .....	950,634	1,203,259
Other assets .....	173,674	414,161
Goodwill, net .....	8,582,845	8,582,845
	-----	-----
Total assets .....	\$ 160,697,599	\$ 131,811,280
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Short-term bank borrowings .....	\$ 15,414,942	\$ 17,951,157
Accounts payable .....	28,028,676	24,394,553
Accrued expenses .....	11,824,895	11,243,179
Income taxes .....	17,597,599	16,826,383
Current portion of long-term obligations .....	44,243,959	19,628,701
	-----	-----
Total current liabilities .....	117,110,071	90,043,973

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Long-term obligations .....	660,425	2,544,546
Convertible debentures, net .....	5,846,657	8,330,483
Deferred tax liabilities .....	152,233	213,784
Minority interest in UAV and PBG7 .....	163,577	--
Commitments and contingencies .....	--	--
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized; no shares (2005) and (2004) issued and outstanding .....	--	--
Common stock, no par value, 100,000,000 shares authorized; 30,553,763 shares (2005) and 28,814,763 shares (2004) issued and outstanding .....	114,977,465	111,515,091
Warrant to purchase common stock .....	2,846,833	2,846,833
Contributed capital .....	9,965,591	9,965,591
Accumulated deficit .....	(88,715,524)	(91,182,959)
Notes receivable from officer/shareholder .....	(2,309,729)	(2,466,062)
Total shareholders' equity .....	36,764,636	30,678,494
Total liabilities and shareholders' equity .....	\$ 160,697,599	\$ 131,811,280
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements

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## TARRANT APPAREL GROUP

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS SEPTEMBER	
	2005	2004	2005	
Net sales .....	\$ 69,566,080	\$ 38,102,733	\$ 164,934,075	\$
Cost of sales .....	55,020,926	33,968,166	129,988,823	
Gross profit .....	14,545,154	4,134,567	34,945,252	
Selling and distribution expenses .....	2,846,445	2,081,389	7,812,476	
General and administrative expenses .....	7,398,722	5,494,741	20,270,148	
Royalty expenses .....	1,288,634	125,000	2,181,325	
Impairment of assets .....	--	--	--	
Income (loss) from operations .....	3,011,353	(3,566,563)	4,681,303	
Interest expense .....	(1,301,271)	(700,451)	(3,400,081)	
Interest income .....	505,913	94,067	1,575,727	

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Other income .....	168,176	383,899	753,894	
Other expense .....	(228)	(194,391)	(559)	
Minority interest .....	(163,576)	180,264	(163,576)	
	-----	-----	-----	---
Income (loss) before provision for income taxes .....	2,220,367	(3,803,175)	3,446,708	
Provision for income taxes .....	517,950	215,511	979,272	
	-----	-----	-----	---
Net income (loss) .....	\$ 1,702,417	\$ (4,018,686)	\$ 2,467,436	\$
	=====	=====	=====	==
Net income (loss) per share:				
Basic .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$
	=====	=====	=====	==
Diluted .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$
	=====	=====	=====	==
Weighted average common and common equivalent shares:				
Basic .....	30,365,502	28,814,763	29,451,054	
	=====	=====	=====	==
Diluted .....	30,785,797	28,814,763	29,517,251	
	=====	=====	=====	==
Net income (loss) .....	\$ 1,702,417	\$ (4,018,686)	\$ 2,467,436	\$
Foreign currency translation adjustment .	--	56,998	--	
	-----	-----	-----	---
Total comprehensive income (loss) .....	\$ 1,702,417	\$ (3,961,688)	\$ 2,467,436	\$
	=====	=====	=====	==

The accompanying notes are an integral part of these consolidated financial statements

## TARRANT APPAREL GROUP

### CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,	
	-----	-----
	2005	2004
	-----	-----
Operating activities:		
Net income (loss) .....	\$ 2,467,436	\$ (75,559,397)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Deferred taxes .....	(61,551)	(31,992)
Depreciation and amortization .....	1,738,937	7,940,452
Asset impairment .....	--	77,982,034
Unrealized gain on foreign currency .....	--	(362,159)
Compensation expense related to stock option .....	38,740	161,037

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Provision for returns and discounts .....	372,805	(323,925)
(Gain) loss on sale of fixed assets .....	(113,968)	8,811
Income from investments .....	(475,947)	(723,450)
Minority interest .....	163,577	(15,196,731)
Changes in operating assets and liabilities:		
Restricted cash .....	--	2,759,742
Accounts receivable .....	(27,473,378)	17,296,369
Due to/from related parties .....	1,982,152	(1,792,814)
Inventory .....	(6,819,037)	9,561,962
Temporary quota rights .....	--	(1,306,543)
Prepaid expenses and other receivables .....	54,471	(127,714)
Accounts payable .....	3,634,123	(5,152,284)
Accrued expenses and income tax payable .....	1,689,190	795,242
	-----	-----
Net cash (used in) provided by operating activities ..	(22,802,450)	15,928,640
Investing activities:		
Net (purchase) sale of fixed assets .....	(452,930)	194,357
Proceeds from sale of fixed assets .....	119,506	3,086,350
Investment in equity investment method .....	--	(75,000)
Distribution from equity investment method .....	216,000	--
Collection on notes receivable .....	977,500	--
Investment in joint venture .....	--	(225,899)
Collection of advances from shareholders/officers .....	2,456,334	20,778
	-----	-----
Net cash provided by investing activities .....	3,316,410	3,000,586
Financing activities:		
Short-term bank borrowings, net .....	(2,536,215)	(1,707,608)
Proceeds from long-term obligations .....	167,099,510	89,259,375
Payment of long-term obligations and bank borrowings ...	(144,655,258)	(111,585,581)
Proceeds from issuance of common stock and warrant .....	--	3,667,765
	-----	-----
Net cash provided by (used in) financing activities ..	19,908,037	(20,366,049)
Effect of exchange rate on cash .....	--	(114,062)
	-----	-----
Decrease in cash and cash equivalents .....	421,997	(1,550,885)
Cash and cash equivalents at beginning of period .....	1,214,944	3,319,964
	-----	-----
Cash and cash equivalents at end of period .....	\$ 1,636,941	\$ 1,769,079
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements

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### 1. ORGANIZATION AND BASIS OF CONSOLIDATION

The accompanying financial statements consist of the consolidation of Tarrant Apparel Group, a California corporation, and its majority owned subsidiaries located primarily in the U.S., Mexico, and Asia. At September 30, 2005, we own 50.1% of United Apparel Ventures ("UAV") and 75% of PBG7, LLC ("PBG7"). We consolidate these entities and reflect the minority interests in earnings (losses) of the ventures in the accompanying financial statements. All inter-company amounts are eliminated in consolidation. The 49.9% minority interest in UAV is owned by Azteca Production International, a corporation owned by the brothers of our Chairman, Gerard Guez. The 25% minority interest in PBG7 is owned by BH7, LLC, an unrelated party.

We serve specialty retail, mass merchandise and department store chains and major international brands by designing, merchandising, contracting for the manufacture of, and selling casual apparel for women, men and children under private label. Commencing in 1999, we expanded our operations from sourcing apparel to sourcing and operating our own vertically integrated manufacturing facilities. In August 2003, we determined to abandon our strategy of being both a trading and vertically integrated manufacturing company, and effective September 1, 2003, we leased and outsourced operation of our manufacturing facilities in Mexico to affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction. In August 2004, we entered into a purchase and sale agreement to sell these facilities to affiliates of Mr. Nacif, which transaction was consummated in the fourth quarter of 2004.

Historically, our operating results have been subject to seasonal trends when measured on a quarterly basis. This trend is dependent on numerous factors, including the markets in which we operate, holiday seasons, consumer demand, climate, economic conditions and numerous other factors beyond our control. Generally, the second and third quarters are stronger than the first and fourth quarters. There can be no assurance that the historic operating patterns will continue in future periods.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results of operations for the periods presented have been included.

The consolidated financial data at December 31, 2004 is derived from audited financial statements which are included in our Annual Report on Form 10-K for the year ended December 31, 2004, as amended, and should be read in conjunction with the audited financial statements and notes thereto. Interim results are not necessarily indicative of results for the full year.

The accompanying unaudited consolidated financial statements include all majority-owned subsidiaries in which we exercise control. Investments in which we exercise significant influence, but which we do not control, are accounted for under the equity method of accounting. The equity method of accounting is used when we have a 20% to 50% interest in other entities, except for variable interest entities for which we are considered the primary beneficiary under Financial Accounting Standards Board ("FASB") Interpretation No. 46, "Consolidation of Variable Interest Entities," an interpretation of ARB No. 51. Under the equity method, original investments are recorded at cost and adjusted by our share of undistributed earnings or losses of these entities. All

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significant intercompany transactions and balances have been eliminated from the consolidated financial statements.

The preparation of financial statements in conformity with US GAAP 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 reporting period. Significant estimates used by us in preparation of the consolidated financial statements include: (i) allowance for returns, discounts and bad debts, (ii) inventory, (iii) valuation of long lived and intangible assets and goodwill, and (iv) income taxes. Actual results could differ from those estimates.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Royalty expenses consist of the royalty payments and marketing fund commitments according to the various licensing agreements we have entered into. Royalty expenses are calculated based on certain percentage of net sales. All of these agreements include minimum royalties. See Note 14 of the "Notes to Consolidated Financial Statements" regarding various agreements we have entered into.

Certain 2004 amounts have been reclassified to conform to the 2005 presentation.

#### 3. STOCK BASED COMPENSATION

We have adopted the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," an amendment of FASB Statement No. 123. This pronouncement requires prominent disclosures in both annual and interim financial statements regarding the method of accounting for stock-based employee compensation and the effect of the method used on reported results. We account for stock compensation awards under the intrinsic-value method of Accounting Principles Board ("APB") Opinion No. 25, rather than the alternative fair-value accounting method. Under the intrinsic-value method, if the exercise price of the employee's stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized.

On September 23, 2005, the Board of Directors approved the acceleration of vesting of all our unvested stock options. In total, 1.7 million stock options with an average exercise price of \$3.69 and an average remaining contractual life of 7.9 years were subject to this acceleration. The exercise prices and number of shares subject to the accelerated options were unchanged. The acceleration was effective as of September 23, 2005. Had the acceleration of these stock options not been undertaken, the future compensation expense we would recognize in the fiscal years of 2006, 2007, 2008 and 2009 would be \$1.4 million, \$810,000, \$10,000 and \$3,000, respectively. Our decision to accelerate the vesting of these stock options was based upon the accounting of this \$2.2 million of compensation expense from disclosure-only in 2005 to being included in our statement of operations in 2006 to 2009 based on our anticipated adoption of SFAS No. 123 (revised 2004) "Share-Based Payment" effective in January 2006. For the three months ended September 30, 2005 and 2004, \$39,000 and \$54,000 were



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recorded, respectively, as an expense related to our stock options. For the nine months ended September 30, 2005 and 2004, \$39,000 and \$161,000 were recorded, respectively, as an expense related to our stock options.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. Our pro forma information follows:

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## TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
Net income (loss) as reported .....	\$ 1,702,417	\$ (4,018,686)	\$ 2,467,436	\$ (10,118,417)
Add stock-based employee compensation charges reported in net loss .....	38,740	53,679	38,740	161,000
Pro forma compensation expense, net of tax .....	(3,248,221)	(970,416)	(4,298,193)	(1,387,417)
Pro forma net loss .....	<u>\$ (1,507,064)</u>	<u>\$ (4,935,423)</u>	<u>\$ (1,792,017)</u>	<u>\$ (10,957,834)</u>
Net income (loss) per share as reported - Basic .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$ (0.17)
Add stock-based employee compensation charges reported in net loss - Basic ..	--	--	--	--
Pro forma compensation expense per share -- Basic .....	(0.11)	(0.03)	(0.14)	(0.05)
Pro forma loss per share -- Basic .....	<u>\$ (0.05)</u>	<u>\$ (0.17)</u>	<u>\$ (0.06)</u>	<u>\$ (0.22)</u>
Net income (loss) per share as reported -- Diluted .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$ (0.17)
Add stock-based employee compensation charges reported in net loss - Diluted	--	--	--	--
Pro forma compensation expense per share -- Diluted .....	(0.11)	(0.03)	(0.14)	(0.05)
Pro forma loss per share -- Diluted .....	<u>\$ (0.05)</u>	<u>\$ (0.17)</u>	<u>\$ (0.06)</u>	<u>\$ (0.22)</u>

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2005 and 2004: weighted-average volatility factors of the expected market price of our common stock of 0.55 for the three months and nine months ended September 30, 2005 and 2004, weighted-average

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risk-free interest rates of 4% for the three months and nine months ended September 30, 2005 and 2004, dividend yield of 0% and weighted-average expected life of the options of 4 years. These pro forma results may not be indicative of the future results for the full fiscal year due to potential grants, vesting and other factors.

### 4. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
	-----	-----
U.S. trade accounts receivable .....	\$ 6,717,320	\$ 3,248,887
Foreign trade accounts receivable .....	17,614,864	17,148,600
Factored accounts receivable .....	41,357,978	19,452,756
Other receivables .....	2,197,742	346,965
Allowance for returns, discounts and bad debts .	(3,027,988)	(2,437,865)
	-----	-----
	\$ 64,859,916	\$ 37,759,343
	=====	=====

### 5. INVENTORY

Inventory consists of the following:

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
	-----	-----
Raw materials - fabric and trim accessories ....	\$ 2,392,647	\$ 1,164,977
Finished goods shipments-in-transit .....	7,184,557	9,283,022
Finished goods .....	16,787,217	8,696,106
	-----	-----
	\$26,364,421	\$19,144,105
	=====	=====

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## TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

### 6. EQUITY METHOD INVESTMENT - AMERICAN RAG

In the second quarter of 2003, we acquired a 45% equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores for \$1.4 million, and our subsidiary, Private Brands, Inc., acquired a license to certain exclusive rights to this trademark. We have guaranteed the payment to the licensor of minimum royalties of \$10.4 million over the initial 10-year term of the agreement. Private Brands also entered into a multi-year exclusive distribution agreement with Macy's Merchandising Group, LLC ("MMG"), the sourcing arm of Federated Department Stores, to supply MMG with American Rag CIE, a casual sportswear collection for juniors and young men. Under this arrangement, Private Brands designs and manufactures American Rag apparel, which is distributed by MMG exclusively to Federated stores across the country. Beginning in August 2003, the American Rag collection was available in

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approximately 100 select Macy's, the Bon Marche, Burdines, Goldsmith's, Lazarus and Rich's-Macy's locations. The investment in American Rag CIE, LLC totaling \$2.1 million at September 30, 2005, is accounted for under the equity method and included in equity method investment on the accompanying consolidated balance sheets. Income from the equity method investment is recorded in the United States geographical segment. The change in investment in American Rag during the nine month ended September 30, 2005 was as follows:

Balance as of December 31, 2004 .....	\$ 1,880,281
Share of income .....	475,947
Distribution .....	(216,000)
	-----
Balance as of September 30, 2005 .....	\$ 2,140,228
	=====

### 7. DEBT

Short-term bank borrowings consist of the following:

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
	-----	-----
Import trade bills payable - UPS, DBS Bank and Aurora Capital .....	\$ 6,457,570	\$ 3,902,714
Bank direct acceptances - UPS and DBS Bank .....	3,000,480	10,447,855
Other Hong Kong credit facilities - UPS and DBS Bank .....	5,956,892	3,600,588
	-----	-----
	\$15,414,942	\$17,951,157
	=====	=====

Long-term obligations consist of the following:

	SEPTEMBER 30, 2005	DECEMBER 31, 2004
	-----	-----
Vendor financing .....	\$ 26,789	\$ 135,145
Equipment financing .....	66,031	78,038
Term loan - UPS .....	3,125,000	5,000,000
Debt facility - GMAC .....	41,686,564	16,960,064
	-----	-----
	44,904,384	22,173,247
Less current portion .....	(44,243,959)	(19,628,701)
	-----	-----
	\$ 660,425	\$ 2,544,546
	=====	=====

### IMPORT TRADE BILLS PAYABLE, BANK DIRECT ACCEPTANCES AND OTHER HONG KONG CREDIT FACILITIES

On June 13, 2002, we entered into a letter of credit facility of \$25 million with UPS Capital Global Trade Finance Corporation ("UPS"). Under this facility, we may arrange for the issuance of letters of credit and acceptances. The facility is collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by Tarrant Apparel Group and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman, also signed a guarantee of \$5 million in favor of UPS to secure this facility. This facility bore interest at 7.75% per annum at September 30, 2005. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. On June 27, 2005, we amended

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the letter of credit facility with UPS to extend the expiration date of the facility from June 30, 2005 to August 31,

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#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2005 and to reduce the tangible net worth requirement at June 30, 2005. On August 31, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from August 31, 2005 to October 31, 2005, immediately reduce the maximum amount of borrowings to \$14.5 million on September 1, 2005 and further reduced the maximum amount of borrowing to \$14.0 million on October 1, 2005. On October 31, 2005, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from October 31, 2005 to January 31, 2006 and amend the interest rate to "prime rate" plus 3%. The most recent facility amendment also provides for reduction in the maximum amount of borrowings to \$13.5 million commencing on November 1, 2005, to \$13 million commencing on December 1, 2005, and to \$12.5 million commencing on January 1, 2006. Additionally, Gerard Guez, our Chairman, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of \$22 million at December 31, 2004, March 31, 2005 and June 30, 2005, and \$25 million as of the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of \$800,000. As of September 30, 2005, we were in compliance with the covenants. As of September 30, 2005, \$11.3 million was outstanding under this facility with UPS (classified above as follows: \$3.9 million in import trade bills payable; \$3.0 million in bank direct acceptances and \$4.4 million in other Hong Kong credit facilities) and an additional \$0.8 million was available for future borrowings. In addition, \$2.4 million of open letters of credit was outstanding as of September 30, 2005.

Since March 2003, DBS Bank (Hong Kong) Limited (formerly known as Dao Heng Bank) has made available a letter of credit facility of up to HKD 20 million (equivalent to US \$2.6 million) to our subsidiaries in Hong Kong. This is a demand facility and is secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman, and Todd Kay, our Vice Chairman, and by our guarantee. The letter of credit facility was increased to HKD 30 million (equivalent to US \$3.9 million) in June 2004. As of September 30, 2005, \$2.9 million was outstanding under this facility. In addition, \$0.8 million of open letters of credit was outstanding and \$91,000 was available for future borrowings as of September 30, 2005. In October 2004, a tax loan for HKD 7.725 million (equivalent to US \$977,000) was also made available to our Hong Kong subsidiaries. As of September 30, 2005, \$171,000 was outstanding under this loan.

As of September 30, 2005, the total balance outstanding under the DBS Bank credit facilities was \$3.1 million (classified above as follows: \$1.5 million in import trade bills payable, \$0.1 million in bank direct acceptances and \$1.5 million in other Hong Kong credit facilities).

From time to time, we open letters of credit under an uncommitted line of credit from Aurora Capital Associates which issues these letters of credits out of Israeli Discount Bank. As of September 30, 2005, \$1.0 million was outstanding under this facility (classified above under import trade bills

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payable) and \$5.1 million of letters of credit were open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

### LOAN FROM MAX AZRIA

On February 14, 2005, we borrowed \$5.0 million from Max Azria, which amount bore interest at the rate of 4% per annum and was payable in weekly installments of \$250,000 beginning on February 28, 2005. This was an unsecured loan. In early August 2005, we repaid the loan in its entirety.

### EQUIPMENT FINANCING

We had two equipment loans outstanding at September 30, 2005 totaling \$66,000 bearing interest at 6% payable in installments through 2009.

### TERM LOAN - UPS

On December 31, 2004, our Hong Kong subsidiaries entered into a new loan agreement with UPS pursuant to which UPS made a \$5 million term loan, the proceeds of which were used to repay \$5 million of indebtedness owed to UPS under the letter of credit of facility. The principal amount of this loan is due and payable in 24 equal monthly installments of approximately \$208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. This facility bore interest at 8.75% per annum at September 30, 2005. On June 27, 2005, we amended the loan agreement

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## TARRANT APPAREL GROUP

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with UPS to reduce the tangible net worth requirement at June 30, 2005. Under the amended loan agreement, we are subject to restrictive financial covenants of maintaining tangible net worth of \$22 million at December 31, 2004, March 31, 2005 and June 30, 2005, and \$25 million as of the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditure per quarter at \$800,000. As of September 30, 2005, we were in compliance with the covenants. As of September 30, 2005, \$3.1 million was outstanding. The obligations under the loan agreement are collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan is secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of \$2,550,000 and \$1,360,000 and a pledge by Gerard Guez, our Chairman, of 4.6 million shares of our common stock.

### DEBT FACILITY- GMAC

We were previously party to a revolving credit, factoring and security agreement (the "Debt Facility") with GMAC Commercial Credit, LLC ("GMAC"). This Debt Facility provided a revolving facility of \$90 million, including a letter of credit facility not to exceed \$20 million, and was scheduled to mature on January 31, 2005. The Debt Facility also provided a term loan of \$25 million, which was being repaid in monthly installments of \$687,500. The Debt Facility provided for interest at LIBOR plus the LIBOR rate margin determined by the Total Leverage Ratio (as defined in the Debt Facility agreements), and was

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collateralized by our receivables, intangibles, inventory and various other specified non-equipment assets. In May 2004, the maximum facility amount was reduced to \$45 million in total and we established new financial covenants with GMAC for the fiscal year of 2004.

On October 1, 2004, we amended and restated the Debt Facility with GMAC by entering into a new factoring agreement with GMAC. The amended and restated agreement (the factoring agreement) extended the expiration date of the facility to September 30, 2007 and added as parties our subsidiaries Private Brands, Inc and No! Jeans, Inc. In addition, in connection with the factoring agreement, our indirect majority-owned subsidiary PBG7, LLC entered into a separate factoring agreement with GMAC. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC, as factor, all accounts which arise from our sale of merchandise or rendition of service created on a going forward basis. At our request, GMAC, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC has the risk of loss and (b) \$40 million, minus in each case, any amount owed by us to GMAC. Pursuant to the terms of the PBG7 factoring agreement, PBG7 agreed to assign and sell to GMAC, as factor, all accounts, which arise from PBG7's sale of merchandise or rendition of services created on a going-forward basis. At PBG7's request, GMAC, in its discretion, may make advances to PBG7 up to the lesser of (a) up to 90% of PBG7's accounts on which GMAC has the risk of loss, and (b) \$5 million minus in each case, any amounts owed to GMAC by PBG7. The facility bears interest at 6.86% per annum and the facility under PBG7, LLC bears interest at 7.25% per annum at September 30, 2005. Restrictive covenants under the revised facility include a limit on quarterly capital expenses of \$800,000 and tangible net worth of \$20 million at September 30, 2004, \$22 million at December 31, 2004 and March 31, 2005 and \$25 million at the end of each fiscal quarter thereafter beginning on June 30, 2005. On June 29, 2005, GMAC agreed to reduce the tangible net worth requirement at June 30, 2005 from \$25 million to \$22 million. The tangible net worth requirement of \$25 million resumes at September 30, 2005 and at the end of each fiscal quarter thereafter. As of September 30, 2005, we were in compliance with the covenants. A total of \$38.7 million was outstanding with respect to receivables factored under the GMAC facility at September 30, 2005.

In May 2005, we amended our factoring agreement with GMAC to permit our subsidiaries party thereto and us, to borrow up to the lesser of \$3 million or fifty percent (50%) of the value of eligible inventory. The maximum borrowing availability under the factoring agreement, based on a borrowing base formula, remained \$40 million. In connection with this amendment, we granted GMAC a lien on certain of our inventory located in the United States. A total of \$3.0 million was outstanding under the GMAC facility at September 30, 2005 with respect to collateralized inventory.

The credit facility with GMAC and the credit facility with UPS carry cross-default clauses. A breach of a financial covenant set by GMAC or UPS constitutes an event of default under the other credit facility, entitling both financial institutions to demand payment in full of all outstanding amounts under their respective debt and credit facilities.

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8. CONVERTIBLE DEBENTURES AND WARRANTS

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On December 14, 2004, we completed a \$10 million financing through the issuance of (i) 6% Secured Convertible Debentures ("Debentures") and (ii) warrants to purchase up to 1,250,000 shares of our common stock. Prior to maturity, the investors may convert the Debentures into shares of our common stock at a price of \$2.00 per share. The warrants have a term of five years and an exercise price of \$2.50 per share. The warrants were valued at \$866,000 using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 4%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.55; and an expected life of four years. The Debentures bear interest at a rate of 6% per annum and have a term of three years. We may elect to pay interest on the Debentures in shares of our common stock if certain conditions are met, including a minimum market price and trading volume for our common stock. The Debentures contain customary events of default and permit the holder thereof to accelerate the maturity if the full principal amount together with interest and other amounts owing upon the occurrence of such events of default. The Debentures are secured by a subordinated lien on certain of our accounts receivable and related assets. The closing market price of our common stock on the closing date of the financing was \$1.96. The convertible debenture was thus valued at \$8,996,000, resulting in an effective conversion price of \$1.799 per share. The intrinsic value of the conversion option of \$804,000 is being amortized over the life of the loan. The value of the warrants of \$866,000 and the intrinsic value of the conversion option of \$804,000 were netted from the \$10 million presented as the convertible debentures, net on our accompanying balance sheets at December 31, 2004.

The placement agent in the financing, received compensation for its services in the amount of \$620,000 in cash and issuance of five year warrants to purchase up to 200,000 shares of our common stock at an exercise price of \$2.50 per share. The warrants to purchase 200,000 shares of our common stock were valued at \$138,000 using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 4%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.55; and an expected life of four years. The \$620,000 financing cost paid to the placement agent and the value of the warrants to purchase 200,000 shares of our common stock of \$138,000 are included in the deferred financing cost, net on our accompanying balance sheets and are amortized over the life of the loan.

In June 2005, holders of our Debentures converted an aggregate of \$2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of \$820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of \$2.00 per share. Debt discount of \$248,000 related to the intrinsic value of the conversion option of \$804,000 was expensed upon the conversion. Of the \$620,000 financing cost paid to the placement agent, \$191,000 was expensed upon the conversion. The intrinsic value of the conversion option, and the value of the warrant amortized in the first nine months of 2005 was \$355,000. Total deferred financing cost amortized in the first nine months of 2005 was \$142,000. Total interest paid to the holders of the Debentures in the first nine months of 2005 was \$435,000. As of September 30, 2005, \$5.8 million, net of \$1.1 million of debt discount, remained outstanding under the Debentures.

### 9. EQUITY TRANSACTIONS

In March 2005, in connection with a settlement of a dispute involving a former employee named Nicolas Nunez, we agreed to compensate Mr. Nunez in the total amount of \$875,000. In April 2005, we issued 195,313 shares of our common stock (having a value of \$375,000) to Mr. Nunez pursuant to the terms of an agreement and plan of reorganization and paid Mr. Nunez \$500,000 in settlement of all remaining claims by Mr. Nunez against us.

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In June 2005, holders of our Debentures converted an aggregate of \$2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of \$820,000 of Debentures into 410,000 shares of our common stock. See Note 8 of the "Notes to Consolidated Financial Statements."

### 10. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which addresses the accounting for employee stock options. SFAS No. 123R eliminates the ability to account for share-based compensation

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## TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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transactions using APB Opinion No. 25 and generally would require instead that such transactions be accounted for using a fair value-based method. SFAS No. 123R also requires that tax benefits associated with these share-based payments be classified as financing activities in the statement of cash flow rather than operating activities as currently permitted. SFAS No. 123R is effective as of the beginning of our first annual or interim reporting period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission adopted a new rule amending the effective date for Statement 123R for public companies. Under the effective date provisions included in Statement 123R, registrants would have been required to implement the Statement's requirements as of the beginning of the first interim or annual period beginning after June 15, 2005, or after December 15, 2005 for small business issuers. The new rule allows registrants to implement Statement 123R at the beginning of their next fiscal year, instead of the next interim period, that begins after June 15, 2005. SFAS No. 123R offers alternative methods of adopting this final rule. We have not yet determined which alternative method we will use.

In May 2005, the FASB issued SFAS No. 154, "Accounting for Changes and Error Corrections." SFAS 154 establishes standards for the accounting and reporting for changes in accounting principles. SFAS 154 replaces APB 20 "Accounting Changes" and FASB Interpretation No. 20 ("FIN 20"), "Reporting Accounting Changes under AICPA Statements of Position." The Statement requires retrospective application for changes in accounting principle, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement would require that the new accounting policy be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for the period. When it is impracticable for an entity to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement would require the new accounting principle to be applied as if it were made prospectively from the earliest date practicable. SFAS 154 is effective as of the beginning of our first annual reporting period that begins after December 15, 2005. The adoption of this new accounting pronouncement is not expected to have a material impact on our consolidated financial statements.



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## 11. INCOME TAXES

Our effective tax rate differs from the statutory rate principally due to the following reasons: (1) a full valuation allowance has been provided for deferred tax assets as a result of the operating losses in the United States and Mexico, since recoverability of those assets has not been assessed as more likely than not; (2) although we have taxable losses in Mexico, we are subject to a minimum tax; and (3) the earnings of our Hong Kong subsidiary are taxed at a rate of 17.5% versus the 35% U.S. federal rate. The impairment charge in Mexico did not result in a tax benefit due to an increase in the valuation allowance against the future tax benefit. We believe it is more likely than not that the tax benefit will not be realized based on our future business plans in Mexico.

In January 2004, the Internal Revenue Service ("IRS") completed its examination of our Federal income tax returns for the years ended December 31, 1996 through 2001. The IRS has proposed adjustments to increase our income tax payable for the six years under examination. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. The proposed adjustments to our 2002 federal income tax return would not result in additional tax due for that year due to the tax loss reported in the 2002 federal return. However, it could reduce the amount of net operating losses available to offset taxes due from the preceding tax years. This adjustment would also result in additional state taxes and interest. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and cash flow. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements under the caption "Income Taxes". The maximum amount of loss in excess of the amount accrued in the financial statements is \$12.6 million. We do not believe that the adjustments, if any, arising from the IRS examination, will result in an additional income tax liability beyond what is recorded in the accompanying consolidated balance sheets.

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## TARRANT APPAREL GROUP

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## 12. NET INCOME (LOSS) PER SHARE

A reconciliation of the numerator and denominator of basic earnings (loss) per share and diluted earnings (loss) per share is as follows:

THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
2005	2004	2005	2004

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## Basic EPS Computation:

Numerator .....	\$ 1,702,417	\$ (4,018,686)	\$ 2,467,436	\$ (75,559,397)
Denominator:				
Weighted average common shares outstanding .....	30,365,502	28,814,763	29,451,054	28,705,274
	-----	-----	-----	-----
Basic EPS .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$ (2.63)
	=====	=====	=====	=====

## Diluted EPS Computation:

Numerator .....	\$ 1,702,417	\$ (4,018,686)	\$ 2,467,436	\$ (75,559,397)
Denominator:				
Weighted average common share outstanding .....	30,365,502	28,814,763	29,451,054	28,705,274
Incremental shares from assumed exercise of warrant .....	403,266	--	59,040	--
Incremental shares from assumed exercise of options .....	17,029	--	7,157	--
	-----	-----	-----	-----
Total shares .....	30,785,797	28,814,763	29,517,251	28,705,274
	-----	-----	-----	-----
Diluted EPS .....	\$ 0.06	\$ (0.14)	\$ 0.08	\$ (2.63)
	=====	=====	=====	=====

Basic and diluted loss per share has been computed in accordance with SFAS No. 128, "Earnings Per Share".

For options and warrants outstanding as of September 30, 2005, only 7,157 and 59,040 shares of outstanding options and warrants, respectively, were included in the computation of income per share in the nine months ended September 30, 2005 as the exercise prices of the remaining shares were greater than the average market price for the nine months ended September 30, 2005. All options and warrants were excluded from the computation of loss per share in the nine months ended September 30, 2004, as the impact would be anti-dilutive. The effect of applying "IF Converted Method" to the convertible debenture was anti-dilutive, therefore, it was excluded from the computation of income per share in the nine months ended September 30, 2005. The following table presents outstanding options, warrants and convertible debentures.

	AS OF SEPTEMBER 30,	
	2005	2004
	-----	-----
Options .....	6,745,175	8,759,862
Warrants .....	2,361,732	911,732
Convertible debentures .....	3,456,313	--
	-----	-----
Total .....	12,563,220	9,671,594
	=====	=====

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#### 13. RELATED PARTY TRANSACTIONS

As of September 30, 2005, related party affiliates were indebted to us in the amounts of \$8.9 million. These include amounts due from Gerard Guez, our Chairman. From time to time in the past, we borrowed funds from, and advanced funds to, Mr. Guez. The greatest outstanding balance of such advances to Mr. Guez in the third quarter of 2005 was approximately \$2,352,000. At September 30, 2005, the entire balance due from Mr. Guez totaling \$2.3 million is payable on demand and has been shown as reductions to shareholders' equity. All advances to, and borrowings from, Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$45,000 and \$92,000 for the three months ended September 30, 2005 and 2004, respectively. Total interest paid by Mr. Guez was \$165,000 and \$278,000 for the nine months ended September 30, 2005 and 2004, respectively. Mr. Guez paid expenses on our behalf of approximately \$87,000 and \$98,000 for the three months ended September 30, 2005 and 2004, respectively, which amounts were applied to reduce accrued interest and principal on Mr. Guez's loan. Mr. Guez paid expenses on our behalf of approximately \$321,000 and \$299,000 for the nine months ended September 30, 2005 and 2004, respectively, which amounts were applied to reduce accrued interest and principal on Mr. Guez's loan. These amounts included fuel and related expenses incurred by 477 Aviation, LLC, a company owned by Mr. Guez, when our executives used this company's aircraft for business purposes. Since the enactment of the Sarbanes-Oxley Act in 2002, no further personal loans (or amendments to existing loans) have been or will be made to our executive officers or directors.

On July 1, 2001, we formed an entity to jointly market, share certain risks and achieve economics of scale with Azteca Production International, Inc. ("Azteca"), a corporation owned by the brothers of Gerard Guez, our Chairman, called United Apparel Ventures, LLC ("UAV"). This entity was created to coordinate the production of apparel for a single customer of our branded business. UAV is owned 50.1% by Tag Mex, Inc., our wholly owned subsidiary, and 49.9% by Azteca. Results of the operation of UAV have been consolidated into our results since July 2001 with the minority partner's share of gain and losses eliminated through the minority interest line in our financial statements. Due to the restructuring of our Mexico operations, we discontinued manufacturing for UAV customers in the second quarter of 2004. UAV made purchases from two related parties in Mexico, an affiliate of Azteca and Tag-It Pacific, Inc.

Commencing in June 2003, UAV began selling to Seven Licensing Company, LLC ("Seven Licensing"), jeans wear bearing the brand "Seven7", which was ultimately purchased by Express. Seven Licensing is beneficially owned by Gerard Guez. In the third quarter of 2004, in order to strengthen our own private brand business, we decided to discontinue sourcing for Seven7. Total sales to Seven7 in the three months ended September 30, 2005 and 2004 were \$0 and \$42,000, respectively. Total sales to Seven7 in the nine months ended September 30, 2005 and 2004 were \$0 and \$3.4 million, respectively. In 1998, a California limited liability company owned by our Chairman and Vice Chairman purchased 2,300,000 shares of the common stock of Tag-It Pacific, Inc. ("Tag-It") (or approximately 37% of such common stock then outstanding). Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Commencing in 1998, Tag-It assumed the responsibility for managing and sourcing all trim and packaging used in connection with products manufactured by or on behalf of us in Mexico. Due to the restructuring of our Mexico operations, Tag-It no longer manages our trim and packaging requirements. We purchased \$20,000 and \$465,000 of trim inventory from Tag-It in the three months ended

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September 30, 2005 and 2004, respectively. We purchased \$55,000 and \$1.2 million of trim inventory from Tag-It in the nine months ended September 30, 2005 and 2004, respectively. We purchased \$0 and \$2.0 million of finished goods and service from Azteca and its affiliates in the three months ended September 30, 2005 and 2004, respectively. We purchased \$135,000 and \$7.5 million of finished goods and service from Azteca and its affiliates in the nine months ended September 30, 2005 and 2004, respectively. Our total sales of fabric and service to Azteca in the three months ended September 30, 2005 and 2004 were \$0. Our total sales of fabric and service to Azteca in the nine months ended September 30, 2005 and 2004 were \$63,000 and \$1.0 million, respectively. Pursuant to the operating agreement for UAV, two and one half percent of gross sales of UAV were paid to each of the members of UAV as management fees. Net amount due from these related parties as of September 30, 2005 was \$6.0 million. Of this amount, \$5.2 million was due from Azteca. We have received a commitment from Azteca to make payments of \$200,000 per month starting in October 2005 to repay this balance.

In August 2004, through Tarrant Mexico, S. de R.L. de C.V., our majority owned and controlled subsidiary in Mexico, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time

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of the transaction, which agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates in October 2003, for an aggregate purchase price consisting of: a) \$105,400 in cash and \$3,910,000 by delivery of unsecured promissory notes bearing interest at 5.5% per annum; and b) \$40,204,000, by delivery of secured promissory notes bearing interest at 4.5% per annum, maturing on December 31, 2005 and every year thereafter until December 31, 2014. The secured promissory notes are payable in partial or total amounts anytime prior to the maturity of each note. Included in the \$44.1 million notes receivable - related party on the accompanying balance sheet as of September 30, 2005 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, \$5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased \$2.3 million and \$1.1 million of fabric from Acabados y Terminados in the three months ended September 30, 2005 and 2004, respectively. We purchased \$4.1 million and \$5.3 million of fabric from Acabados y Terminados in the nine months ended September 30, 2005 and 2004, respectively. Net amount due from these parties as of September 30, 2005 was \$238,000.

Under lease agreements we entered into between two entities, GET and Lynx International Limited, owned by our Chairman and Vice Chairman, we paid \$255,000 and \$332,000 in the three months ended September 30, 2005 and 2004, respectively, for office and warehouse facilities. We paid \$764,000 and \$996,000 in the nine months ended September 30, 2005 and 2004, respectively, for office and warehouse facilities. The lease with Lynx International Limited for our Hong Kong facility expires on December 31, 2005. We currently lease our Los Angeles facility from GET on a month-to-month basis.

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At September 30, 2005, we had various employee receivables totaling \$380,000 included in due from related parties.

We believe the each of the transactions described above has been entered into on terms no less favorable to us than could have been obtained from unaffiliated third parties.

### 14. COMMITMENTS AND CONTINGENCIES

On January 3, 2005, Private Brands, Inc, our wholly owned subsidiary, entered into an agreement with Beyond Productions, LLC and Kids Headquarters to collaborate on the design, manufacturing and distribution of women's contemporary apparel bearing the brand name "House of Dereon", Couture, Kick and Soul. This agreement has an initial three-year term, and provided we are in compliance with the terms of the agreement, is renewable for one additional three-year term. Minimum net sales are \$10 million in year 1, \$20 million in year 2 and \$30 million in year 3. The agreement provides for royalty payments of 8% on net sales, and a marketing fund commitment of 3% of net sales, for a total minimum payment obligation of \$6.6 million over the initial term of the agreement. As of September 30, 2005, we have advanced \$1.2 million as payment for the first year's minimum royalty and marketing fund commitment.

On October 17, 2004, Private Brands, Inc entered into an agreement with J. S. Brand Management to design, manufacture and distribute Jessica Simpson branded jeans and casual apparel in missy, juniors and large sizes. This agreement has an initial three-year term, and provided we are in compliance with the terms of the agreement, is renewable for one additional two-year term. Minimum net sales are \$20 million in year 1, \$25 million in year 2 and \$30 million in year 3. The agreement provides for payment of a sales royalty and advertising commitment at the rate of 8% and 3%, respectively, of net sales, for a total minimum payment obligation of \$8.3 million over the initial term of the agreement. On July 19, 2005 Camuto Consulting Group replaced J.S. Brand Management as the master licensor. As of September 30, 2005, we had advanced \$2.2 million as payment for the first year's minimum royalties. We had applied \$1.2 million from the advance against the royalty and marketing expenses in the nine months ended September 30, 2005.

In the second quarter of 2003, we acquired a 45% equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores for \$1.4 million, and our subsidiary, Private Brands, Inc., acquired a license to certain exclusive rights to this trademark. We have guaranteed the payment to the licensor of minimum royalties

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of \$10.4 million over the initial 10-year term of the agreement. At September 30, 2005, the total commitment on royalties remaining on the term was \$9.2 million.

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, with agreement was amended in October 2004. Pursuant to the

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agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, \$5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased \$2.3 million and \$3.2 million of fabric under this agreement in the three months and nine months ended September 30, 2005, respectively.

### 15. OPERATIONS BY GEOGRAPHIC AREAS

Our predominant business is the design, distribution and importation of private label and private brand casual apparel. Substantially all of our revenues are from the sales of apparel. We are organized into three geographic regions: the United States, Asia and Mexico. We evaluate performance of each region based on profit or loss from operations before income taxes not including the cumulative effect of change in accounting principles. Information about our operations in the United States, Asia, and Mexico is presented below. Inter-company revenues and assets have been eliminated to arrive at the consolidated amounts.

	UNITED STATES	ASIA	MEXICO	ADJUSTMENTS AND ELIMINATIONS
	-----	-----	-----	-----
THREE MONTHS ENDED SEPTEMBER 30, 2005				
Sales .....	\$ 69,023,000	\$ 536,000	\$ 7,000	\$ --
Inter-company sales .....	--	43,576,000	--	(43,576,000)
	-----	-----	-----	-----
Total revenue .....	\$ 69,023,000	\$ 44,112,000	\$ 7,000	\$ (43,576,000)
	=====	=====	=====	=====
Income (loss) from operations	\$ 275,000	\$ 2,568,000	\$ 168,000	\$ --
	=====	=====	=====	=====
THREE MONTHS ENDED SEPTEMBER 30, 2004				
Sales .....	\$ 37,263,000	\$ 696,000	\$ 144,000	\$ --
Inter-company sales .....	--	17,644,000	780,000	(18,424,000)
	-----	-----	-----	-----
Total revenue .....	\$ 37,263,000	\$ 18,340,000	\$ 924,000	\$ (18,424,000)
	=====	=====	=====	=====
Income (loss) from operations	\$ (3,234,000)	\$ 554,000	\$ (887,000)	\$ --
	=====	=====	=====	=====
NINE MONTHS ENDED SEPTEMBER 30, 2005				
Sales .....	\$ 163,828,000	\$ 1,006,000	\$ 100,000	\$ --
Inter-company sales .....	--	105,576,000	--	(105,576,000)
	-----	-----	-----	-----
Total revenue .....	\$ 163,828,000	\$ 106,582,000	\$ 100,000	\$ (105,576,000)
	=====	=====	=====	=====
Income (loss) from operations	\$ (571,000)	\$ 5,444,000	\$ (192,000)	\$ --
	=====	=====	=====	=====

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NINE MONTHS ENDED

SEPTEMBER 30, 2004

Sales .....	\$ 113,042,000	\$ 1,713,000	\$ 3,992,000	\$ --
Inter-company sales .....	--	56,243,000	7,440,000	(63,683,000)
	-----	-----	-----	-----
Total revenue .....	\$ 113,042,000	\$ 57,956,000	\$ 11,432,000	\$ (63,683,000)
	=====	=====	=====	=====
Income (loss) from operations (1)	\$ (8,725,000)	\$ 3,116,000	\$ (88,565,000)	\$ --
	=====	=====	=====	=====

- (1) Included in Income (loss) from operations an impairment charge of \$78.0 million in Mexico region.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

### BUSINESS OVERVIEW AND RECENT DEVELOPMENTS

We are a design and sourcing company for private label and private brand casual apparel serving mass merchandisers, department stores, branded wholesalers and specialty chains located primarily in the United States. Our major customers include leading retailers, such as Chico's, Macy's Merchandising Group, the Avenue, Lane Bryant, Lerner New York, J.C. Penney, K-Mart, Kohl's, Mervyn's and Wal-Mart. Our products are manufactured in a variety of woven and knit fabrications and include jeans wear, casual pants, t-shirts, shorts, blouses, shirts and other tops, dresses and jackets. Our private brands include American Rag Cie, Jessica Simpson, Princy by Jessica Simpson, House of Dereon by Tina Knowles, No! Jeans, Alain Weiz, and Gear 7.

During the first quarter of 2005, we extended our agreement with Macy's Merchandising Group for six years, pursuant to which we exclusively distribute our American Rag Cie brand through Macy's Merchandising Group's national Department Store organization of more than 300 stores. During the third quarter of 2005, we were informed by K-Mart that it would discontinue with the Gear 7 brand. While we are pursuing other relationships for the Gear 7 brand, there will be a decline in sales for this brand in the fourth quarter of 2005 as a result of the discontinuance. Alain Weiz continues to be exclusive to Dillard's Department Stores. Sales of Jessica Simpson and Princy by Jessica Simpson totaled \$10.7 million in the third quarter of 2005. We began shipping House of Dereon by Tina Knowles in the fourth quarter of 2005. The Jessica Simpson brand was originally launched as a denim line with Charming Shoppes. However, Charming Shoppes is not going forward with the line, and we are currently in discussion with other large volume, middle market retailers who would support the brand as a multi-category collection. During the third quarter of 2005, the master license for Jessica Simpson was changed to the Camuto Consulting Group. We expect this relationship to add a great deal of value to the Jessica Simpson related brands.

The success of our Private Brands collections has created new opportunities within the Private Label business to add value in the development and marketing of new initiatives for Sears, Mothers Work, Avenue, Chico's, and other retailers. These initiatives were launched during the first nine months of 2005.

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### INTERNAL REVENUE SERVICE AUDIT

In January 2004, the Internal Revenue Service completed its examination of our Federal income tax returns for the years ended December 31, 1996 through 2001. The IRS has proposed adjustments to increase our income tax payable for the six years under examination. This adjustment would also result in additional state taxes and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. The proposed adjustments to our 2002 federal income tax return would not result in additional tax due for that year due to the tax loss reported in the 2002 federal return. However, it could reduce the amount of net operating losses available to offset taxes due from the preceding tax years. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and cash flow. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements under the caption "Income Taxes". The maximum amount of loss in excess of the amount accrued in the financial statements is \$12.6 million. We do not believe that the adjustments, if any, arising from the IRS examination, will result in an additional income tax liability beyond what is recorded in the accompanying consolidated balance sheets.

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We are required to make assumptions about matters, which are

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highly uncertain at the time of the estimate. Different estimates we could reasonably have used or changes in the estimates that are reasonably likely to occur could have a material effect on our financial condition or result of operations. Estimates and assumptions about future events and their effects cannot be determined with certainty. On an ongoing basis, we evaluate estimates, including those related to returns, discounts, bad debts, inventories, intangible assets, income taxes, and contingencies and litigation. We base our estimates on historical experience and on various assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged period of time.

We believe our financial statements are fairly stated in accordance with accounting principles generally accepted in the United States of America and provide a meaningful presentation of our financial condition and results of operations.



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We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For a further discussion on the application of these and other accounting policies, see Note 1 of the "Notes to Consolidated Financial Statements" included in our Annual Report on Form 10-K for the year ended December 31, 2004.

### ACCOUNTS RECEIVABLE--ALLOWANCE FOR RETURNS, DISCOUNTS AND BAD DEBTS

We evaluate the collectibility of accounts receivable and chargebacks (disputes from the customer) based upon a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations (such as in the case of bankruptcy filings or substantial downgrading of credit sources), a specific reserve for bad debts is taken against amounts due to reduce the net recognized receivable to the amount reasonably expected to be collected. For all other customers, we recognize reserves for bad debts and chargebacks based on our historical collection experience. If our collection experience deteriorates (for example, due to an unexpected material adverse change in a major customer's ability to meet its financial obligations to us), the estimates of the recoverability of amounts due us could be reduced by a material amount.

As of September 30, 2005, the balance in the allowance for returns, discounts and bad debts reserves was \$3.0 million.

### INVENTORY

Our inventories are valued at the lower of cost or market. Under certain market conditions, we use estimates and judgments regarding the valuation of inventory to properly value inventory. Inventory adjustments are made for the difference between the cost of the inventory and the estimated market value and charged to operations in the period in which the facts that give rise to the adjustments become known.

### VALUATION OF LONG-LIVED AND INTANGIBLE ASSETS AND GOODWILL

We assess the impairment of identifiable intangibles, long-lived assets and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important that could trigger an impairment review include, but are not limited to, the following:

- o a significant underperformance relative to expected historical or projected future operating results;
- o a significant change in the manner of the use of the acquired asset or the strategy for the overall business; or
- o a significant negative industry or economic trend.

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets." According to this statement, goodwill and other intangible assets with indefinite lives are no longer subject to amortization, but rather an assessment of impairment applied on a fair-value-based test on

an annual basis or more frequently if an event occurs or circumstances change

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that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

We utilized the discounted cash flow methodology to estimate fair value. As of September 30, 2005, we have a goodwill balance of \$8.6 million, and a net property and equipment balance of \$1.7 million.

### INCOME TAXES

As part of the process of preparing our consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which we operate. The process involves estimating actual current tax expense along with assessing temporary differences resulting from differing treatment of items for book and tax purposes. These timing differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. Management records a valuation allowance to reduce our net deferred tax assets to the amount that is more likely than not to be realized. Management has considered future taxable income and ongoing tax planning strategies in assessing the need for the valuation allowance. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of operations.

In addition, accruals are also estimated for ongoing audits regarding U.S. Federal tax issues that are currently unresolved, based on our estimate of whether, and the extent to which, additional taxes will be due. We routinely monitor the potential impact of these situations and believe that amounts are properly accrued for. If we ultimately determine that payment of these amounts is unnecessary, we will reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We will record an additional charge in our provision for taxes in any period we determine that the original estimate of a tax liability is less than we expect the ultimate assessment to be. See Note 11 of the "Notes to Consolidated Financial Statements" for a discussion of current tax matters.

### DEBT COVENANTS

Our debt agreements require certain covenants including a minimum level of net worth as discussed in Note 7 of the "Notes to Consolidated Financial Statements." If our results of operations erode and we are not able to obtain waivers from the lenders, the debt would be in default and callable by our lenders. In addition, due to cross-default provisions in our debt agreements, substantially all of our long-term debt would become due in full if any of the debt is in default. In anticipation of us not being able to meet the required covenants due to various reasons, we either negotiate for changes in the relative covenants or obtain an advance waiver or reclassify the relevant debt as current. We also believe that our lenders would provide waivers if necessary. However, our expectations of future operating results and continued compliance with other debt covenants cannot be assured and our lenders' actions are not controllable by us. If projections of future operating results are not achieved and the debt is placed in default, we would be required to reduce our expenses, by curtailing operations, and to raise capital through the sale of assets, issuance of equity or otherwise, any of which could have a material adverse effect on our financial condition and results of operations.

### NEW ACCOUNTING PRONOUNCEMENTS

For a description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition, see Note 10 of the "Notes to Consolidated Financial Statements."

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## RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain items in our consolidated statements of operations as a percentage of net sales:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
Net sales .....	100.0%	100.0%	100.0%	100.0%
Cost of sales .....	79.1	89.1	78.8	85.8
Gross profit .....	20.9	10.9	21.2	14.2
Selling and distribution expenses .....	4.1	5.5	4.7	6.0
General and administration expenses .....	10.6	14.4	12.3	21.5
Royalty and marketing allowance expenses .....	1.9	0.4	1.3	0.4
Impairment of assets .....	0.0	--	0.0	65.6
Income (loss) from operations .....	4.3	(9.4)	2.9	(79.3)
Interest expense .....	(1.9)	(1.8)	(2.1)	(1.8)
Interest Income .....	0.7	0.3	1.0	0.2
Other income .....	0.3	1.0	0.4	5.9
Other expense .....	(0.0)	(0.5)	(0.0)	(0.5)
Minority interest .....	(0.2)	0.5	(0.1)	12.8
Income (loss) before taxes .....	3.2	(9.9)	2.1	(62.7)
Income taxes .....	0.7	0.6	0.6	0.9
Net income (loss) .....	2.5%	(10.5)%	1.5%	(63.6)%

## THIRD QUARTER 2005 COMPARED TO THIRD QUARTER 2004

Net sales increased by \$31.5 million, or 82.6%, to \$69.6 million in the third quarter of 2005 from \$38.1 million in the third quarter of 2004. The increase in net sales in the third quarter of 2005 was primarily due to increased sales of Private Brands, which was \$22.6 million in the third quarter of 2005 compared to \$2.8 million in the same period of 2004. Gear 7, Jessica Simpson and Princy by Jessica Simpson recorded significant sales contributions in the third quarter of 2005, as compared to no sales for these brands in the third quarter of 2004. We expect sales of these brands to decline significantly in the fourth quarter of 2005 due to the discontinuance by Gear 7 line by K-Mart and Charming Shoppes' decision not to continue with the Jessica Simpson line. Private Label sales for the third quarter of 2005 were \$47.0 million compared to \$35.3 million in the third quarter of 2004, with the increase resulting primarily from increased sales to Chico's, Sears and Wal-Mart in the third quarter of 2005.

Gross profit consists of net sales less product costs, direct labor, manufacturing overhead, duty, quota, freight in, brokerage, and warehousing. Gross profit increased by \$10.4 million to \$14.5 million in the third quarter of 2005 from \$4.1 million in the third quarter of 2004. The increase in gross

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profit occurred primarily because of an increase in sales and gross margin. As a percentage of net sales, gross profit increased from 10.9% in the third quarter of 2004 to 20.9% in the third quarter of 2005. The improvement in gross margin is primarily attributable to the change of relative product mix in favor of the higher margin Private Brands business as compared to Private Label as well as improved margins in the Private label business due to expansion of our business to include more knitwear and woven tops at better margin using Private Brand product developments.

Selling and distribution expenses increased by \$765,000, or 36.8%, to \$2.8 million in the third quarter of 2005 from \$2.1 million in the third quarter of 2004. As a percentage of net sales, these expenses decreased to 4.1% in the third quarter of 2005 from 5.5% in the third quarter of 2004 due to increased sales during the third quarter of 2005.

General and administrative expenses increased by \$1.9 million, or 34.7%, to \$7.4 million in the third quarter of 2005 from \$5.5 million in the third quarter of 2004. The increase was primarily due to the costs associated with developing multiple new lines in the Private Brands business, primarily personnel. As a percentage of net sales, these expenses decreased to 10.6% in the third quarter of 2005 from 14.4% in the third quarter of 2004.

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Royalty and marketing allowance expenses increased by \$1.2 million, or 930.9%, to \$1.3 million in the third quarter of 2005 from \$125,000 in the third quarter of 2004. The increase was primarily due to our sales under the Alain Weiz, and Jessica Simpson brands. As a percentage of net sales, these expenses increased to 1.9% in the third quarter of 2005 from 0.4% in the third quarter of 2004.

Operating income in the third quarter of 2005 was \$3.0 million, or 4.3% of net sales, compared to operating loss of \$3.6 million, or 9.4% of net sales, in the comparable period of 2004, because of the factors discussed above.

Interest expense increased by \$601,000 or 85.8%, to \$1.3 million in the third quarter of 2005 from \$700,000 in the third quarter of 2004. As a percentage of net sales, this expense increased to 1.9% in the third quarter of 2005 from 1.8% in the third quarter of 2004. The increase was partly due to interest expenses of \$283,000 in the third quarter of 2005 related to interest payments to holders of Debentures and amortization of debt discount arising from issuing convertible debentures, compared to no such expense in the third quarter of 2004. Interest income increased by \$412,000 to \$506,000 in the third quarter of 2005 from \$94,000 in the third quarter of 2004. The increase was primarily due to the interest earned from the notes receivable related to the sale of our fixed assets in Mexico of \$460,000 during the third quarter of 2005, compared to no such income in the third quarter of 2004.

Income from the equity method investments, UAV and PBG7, totaled approximately \$164,000 for the third quarter of 2005. Losses allocated to minority interests in the third quarter of 2004 were \$180,000, representing the minority partner's share of losses in each of UAV and PBG7.

### FIRST NINE MONTHS OF 2005 COMPARED TO FIRST NINE MONTHS OF 2004

Net sales increased by \$46.2 million, or 38.9%, to \$164.9 million in the first nine months of 2005 from \$118.7 million in the first nine months of 2004. The increase in net sales in the first nine months of 2005 was primarily due to increased sales of Private Brands, which was \$45.4 million in the first

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nine months of 2005 compared to \$14.3 million in the same period of 2004. Gear 7, Alain Weiz, Jessica Simpson and Princy by Jessica Simpson recorded significant sales contributions in the first nine months of 2005. We expect sales of these brands to decline significantly in the fourth quarter of 2005 due to the discontinuance by Gear 7 line by K-Mart and Charming Shoppes' decision not to continue with the Jessica Simpson line. Private Label sales for the first nine months of 2005 were \$119.5 million compared to \$104.4 million in the first nine months of 2004, with the increase resulting primarily from increased sales to Chico's, Mothers Work, Sears and Wal-Mart and a decrease in the sale of close-out inventory and fabric from \$7.7 million in the first nine months of 2004 compared to \$1.4 million in the first nine months of 2005.

Gross profit increased by \$18.0 million to \$34.9 million in the first nine months of 2005 from \$16.9 million in the first nine months of 2004. The increase in gross profit occurred primarily because of an increase in sales and improved gross margin. As a percentage of net sales, gross profit increased from 14.2% in the first nine months of 2004 to 21.2% in the first nine months of 2005. The improvement in gross margin is primarily attributable to the change of relative product mix in favor of the higher margin Private Brands business as compared to Private Label, and the reduction of close-out inventory and fabric sales in the first nine months of 2005 as compared to the prior year period.

Selling and distribution expenses increased by \$702,000, or 15.0%, to \$7.8 million in the first nine months of 2005 from \$7.1 million in the first nine months of 2004. As a percentage of net sales, these expenses decreased from 6.0% for the first nine months of 2004 to 4.7% for the first nine months of 2005 due to increased sales in the first nine months of 2005.

General and administrative expenses decreased by \$5.3 million, or 20.7%, to \$20.3 million in the first nine months of 2005 from \$25.6 million in the first nine months of 2004. The decrease was primarily due to the depreciation and amortization of our Mexico assets of \$6.7 million and \$1.1 million of severance paid to the Mexican workers in the first nine months of 2004 as compared to no such expense in the first nine months of 2005 after disposition of our fixed assets in Mexico in late 2004. As a percentage of net sales, these expenses decreased to 12.3% in the first nine months of 2005 from 21.5% in the first nine months of 2004.

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Royalty and marketing allowance expenses increased by \$1.8 million, or 422.0%, to \$2.2 million in the first nine months of 2005 from \$418,000 in the first nine months of 2004. The increase was primarily due to our sales under the Alain Weiz and Jessica Simpson brands. As a percentage of net sales, these expenses increased to 1.3% in the first nine months of 2005 from 0.4% in the first nine months of 2004.

Impairment of assets expense was \$0 in the first nine months of 2005, compared to \$78.0 million in the first nine months of 2004. This expense in the first nine months of 2004 was a consequence of our write-down of the book value of our fixed assets in Mexico to their fair value in accordance with SFAS 144.

Operating income for the first nine months of 2005 was \$4.7 million, or 2.9% of net sales, compared to operating loss of \$94.2 million, or 79.3% of net sales, in the comparable prior period of 2004 as a result of the factors discussed above.

Interest expense increased by \$1.2 million, or 55.0%, to \$3.4 million in the first nine months of 2005 from \$2.2 million in the first nine months of

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2004. As a percentage of net sales, this expense increased to 2.1% in the first nine months of 2005 from 1.8% in the first nine months of 2004. The increase was primarily due to interest expenses of \$1.0 million in the first nine months of 2005 related to interest payments to holders of Debentures and amortization of debt discount arising from issuing convertible debenture, compared to no such expense in the first nine months of 2004. Interest income increased by \$1.3 million, to \$1.6 million in the first nine months of 2005 from \$281,000 in the first nine months of 2004. The increase was primarily due to the interest earned from the notes receivable related to the sale of our fixed assets in Mexico of \$1.4 million during the first nine months of 2005, compared to no such income in the first nine months of 2004. Other income was \$754,000 in the first nine months of 2005, compared to \$7.0 million in the first nine months of 2004. This reduction in other income was due primarily to \$5.5 million of lease income received for the lease of our facilities and equipment in Mexico in the first nine months of 2004, compared to no such income in the first nine months of 2005 due to the sale of our Mexico operations in the fourth quarter of 2004.

Earnings from the equity method investments, UAV and PBG7, totaled approximately \$164,000 for the first nine months of 2005. Losses allocated to minority interests in the first nine months of 2004 were \$15.2 million, representing the minority partner's share of losses in UAV and PBG7 totaling \$337,000, and the minority shareholder's share of losses in Tarrant Mexico totaling \$14.9 million, of which \$13.7 million is this shareholder's 25% share of the charge we incurred for the write down of fixed assets in Mexico.

### LIQUIDITY AND CAPITAL RESOURCES

Our liquidity requirements arise from the funding of our working capital needs, principally inventory, finished goods shipments-in-transit, work-in-process and accounts receivable, including receivables from our contract manufacturers that relate primarily to fabric we purchase for use by those manufacturers. Our primary sources for working capital and capital expenditures are cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt, sales of equity and debt securities, and vendor financing. In the near term, we expect that our operations and borrowings under bank and other credit facilities and sales of equity and debt securities will provide sufficient cash to fund our operating expenses, capital expenditures and interest payments on our debt. In the long-term, we expect to use internally generated funds and external sources to satisfy our debt and other long-term liabilities.

Our liquidity is dependent, in part, on customers paying on time. Any abnormal chargebacks or returns may affect our source of short-term funding. Any changes in credit terms given to major customers may have an impact on our cash flow. Suppliers' credit is another major source of short-term financing and any adverse changes in their terms will have negative impact on our cash flow.

Other principal factors that could affect the availability of our internally generated funds include:

- o deterioration of sales due to weakness in the markets in which we sell our products;
- o decreases in market prices for our products;
- o increases in costs of raw materials; and

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- o changes in our working capital requirements.

Principal factors that could affect our ability to obtain cash from external sources include:

- o financial covenants contained in our current or future bank and debt facilities; and
- o volatility in the market price of our common stock or in the stock markets in general.

Cash flows for the nine months ended September 30, 2005 and 2004 were as follows (dollars in thousands):

CASH FLOWS:	2005	2004
-----	-----	-----
Net cash provided by (used in)		
operating activities .....	\$ (22,802)	\$ 15,929
Net cash provided by investing		
activities .....	\$ 3,316	\$ 3,001
Net cash provided by (used in)		
financing activities .....	\$ 19,908	\$ (20,366)

During the first nine months of 2005, net cash used in operating activities was \$22.8 million, as compared to net cash provided by operating activities of \$15.9 million for the same period in 2004. Net cash used in operating activities in the first nine months of 2005 resulted primarily from a net income of \$2.5 million, reduced by increases of \$27.5 million in accounts receivable and \$6.8 million in inventory, partially offset by depreciation and amortization expense of \$1.7 million, an increase of \$3.6 million in account payable and decrease of \$2.0 million due to/from related parties. The increase in accounts receivable, inventory and accounts payable in the first nine months of 2005 was primarily due to increase in sales volume in the current year period.

During the first nine months of 2005, net cash provided by investing activities was \$3.3 million, as compared to net cash provided by investing activities of \$3.0 million for the same period in 2004. Net cash provided by investing activities in the first nine months of 2005 included approximately \$2.5 million of collection of advances from our Chairman and \$1.0 million of collection on notes receivable.

During the first nine months of 2005, net cash provided by financing activities was \$19.9 million, as compared to net cash used in financing activities of \$20.4 million for the same period in 2004. Net cash provided by financing activities in nine months of 2005 included \$2.5 million net repayment of our short-term bank borrowings and \$22.4 million net proceeds from our credit facilities.

### CONTRACTUAL OBLIGATIONS AND COMMITMENTS

Following is a summary of our contractual obligations and commercial commitments available to us as of September 30, 2005 (in millions):

		PAYMENTS DUE BY PERIOD			
		-----			
		Less than	Between	Between	After
		1 year	2-3	4-5	5 years
			years	years	
CONTRACTUAL OBLIGATIONS	Total				

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Long-term debt (1) .....	\$ 44.9	\$ 44.2	\$ 0.7	\$ --	\$ --
Convertible debentures, net .....	6.9	--	6.9	--	--
Operating leases .....	6.5	0.7	1.3	1.2	3.3
Minimum royalties .....	23.8	4.5	12.3	2.1	4.9
Purchase commitment .....	46.8	5.5	10.0	10.0	21.3
Total Contractual Cash Obligations	\$ 128.9	\$ 54.9	\$ 31.2	\$ 13.3	\$ 29.5

(1) Excludes interest on long-term debt obligations. Based on outstanding borrowings as of September 30, 2005, and assuming all such indebtedness remained outstanding and the interest rates remained unchanged, we estimate that our interest cost on long-term debt would be approximately \$4.0 million.

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COMMERCIAL COMMITMENTS AVAILABLE TO US	TOTAL AMOUNTS COMMITTED TO US	AMOUNT OF COMMITMENT EXPIRATION PER PERIOD			
		LESS THAN 1 YEAR	BETWEEN 2-3 YEARS	BETWEEN 4-5 YEARS	AFTER 5 YEARS
Lines of credit .....	\$ 61.4	\$ 61.4	\$ --	\$ --	\$ --
Letters of credit (within lines of credit) .....	\$ 18.9	\$ 18.9	\$ --	\$ --	\$ --
Total commercial commitments .....	\$ 61.4	\$ 61.4	\$ --	\$ --	\$ --

On June 13, 2002, we entered into a letter of credit facility of \$25 million with UPS Capital Global Trade Finance Corporation ("UPS"). Under this facility, we may arrange for the issuance of letters of credit and acceptances. The facility is collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by Tarrant Apparel Group and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman, also signed a guarantee of \$5 million in favor of UPS to secure this facility. This facility bore interest at 7.75% per annum at September 30, 2005. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. On June 27, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from June 30, 2005 to August 31, 2005 and to reduce the tangible net worth requirement at June 30, 2005. On August 31, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from August 31, 2005 to October 31, 2005, immediately reduce the maximum amount of borrowings to \$14.5 million on September 1, 2005 and further reduced the maximum amount of borrowing to \$14.0 million on October 1, 2005. On October 31, 2005, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from October 31, 2005 to January 31, 2006 and amend the interest rate to "prime rate" plus 3%. The most recent facility amendment also provides for reduction in the maximum amount of borrowings to \$13.5 million commencing on November 1, 2005, to \$13 million commencing on December 1, 2005, and to \$12.5 million commencing on January 1, 2006. Additionally, Gerard Guez,



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our Chairman, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of \$22 million at December 31, 2004, March 31, 2005 and June 30, 2005, and \$25 million as of the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of \$800,000. As of September 30, 2005, we were in compliance with the covenants. As of September 30, 2005, \$11.3 million was outstanding under this facility with UPS and an additional \$0.8 million was available for future borrowings. In addition, \$2.4 million of open letters of credit was outstanding as of September 30, 2005.

On December 31, 2004, our Hong Kong subsidiaries entered into a new loan agreement with UPS pursuant to which UPS made a \$5 million term loan, the proceeds of which were used to repay \$5 million of indebtedness owed to UPS under the letter of credit of facility. The principal amount of this loan is due and payable in 24 equal monthly installments of approximately \$208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. This facility bore interest at 8.75% per annum at September 30, 2005. On June 27, 2005, we amended the loan agreement with UPS to reduce the tangible net worth requirement at June 30, 2005. Under the amended loan agreement, we are subject to restrictive financial covenants of maintaining tangible net worth of \$22 million at December 31, 2004, March 31, 2005 and June 30, 2005, and \$25 million as of the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditure per quarter at \$800,000. As of September 30, 2005, we were in compliance with the covenants. As of September 30, 2005, \$3.1 million was outstanding. The obligations under the loan agreement are collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan is secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of \$2,550,000 and \$1,360,000 and a pledge by Gerard Guez, our Chairman, of 4.6 million shares of our common stock.

Since March 2003, DBS Bank (Hong Kong) Limited (formerly known as Dao Heng Bank) has made available a letter of credit facility of up to HKD 20 million (equivalent to US \$2.6 million) to our subsidiaries in Hong Kong. This is a demand facility and is secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Todd Kay, our Vice Chairman, and by our guarantee. The letter of credit facility was increased to HKD 30 million (equivalent to US\$3.9 million) in June 2004. As of September 30, 2005, \$2.9 million was outstanding under this facility. In addition, \$0.8 million of open letters of credit was outstanding and \$91,000 was available for future borrowings as of September 30, 2005. In October 2004, a tax loan for HKD 7.725 million

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(equivalent to US \$977,000) was also made available to our Hong Kong subsidiaries. As of September 30, 2005, \$171,000 was outstanding under this loan.

On October 1, 2004, we amended and restated our previously existing debt facility with GMAC Commercial Credit, LLC ("GMAC") by entering into a new factoring agreement with GMAC. The amended and restated agreement (the factoring agreement) has an expiration date of September 30, 2007. In addition, in connection with the factoring agreement, our indirect majority-owned subsidiary PBG7, LLC entered into a separate factoring agreement with GMAC. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC, as factor, all accounts which arise from our sale of merchandise

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or rendition of service created on a going forward basis. At our request, GMAC, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC has the risk of loss and (b) \$40 million, minus in each case, any amount owed by us to GMAC. Pursuant to the terms of the PBG7 factoring agreement, PBG7 agreed to assign and sell to GMAC, as factor, all accounts, which arise from PBG7's sale of merchandise or rendition of services created on a going-forward basis. At PBG7's request, GMAC, in its discretion, may make advances to PBG7 up to the lesser of (a) up to 90% of PBG7's accounts on which GMAC has the risk of loss, and (b) \$5 million minus in each case, any amounts owed to GMAC by PBG7. The facility bears interest at 6.86% per annum and the facility under PBG7, LLC bears interest at 7.25% at September 30, 2005. Restrictive covenants under the revised facility include a limit on quarterly capital expenses of \$800,000 and tangible net worth of \$20 million at September 30, 2004, \$22 million at December 31, 2004 and March 31, 2005 and \$25 million at the end of each fiscal quarter thereafter beginning on June 30, 2005. On June 29, 2005, GMAC agreed to reduce the tangible net worth requirement at June 30, 2005 from \$25 million to \$22 million. The tangible net worth requirement of \$25 million resumes at September 30, 2005 and at the end of each fiscal quarter thereafter. As of September 30, 2005, we were in compliance with the covenants. A total of \$38.7 million was outstanding with respect to receivables factored under the GMAC facility at September 30, 2005.

In May 2005, we amended our factoring agreement with GMAC to permit our subsidiaries party thereto and us, to borrow up to the lesser of \$3 million or fifty percent (50%) of the value of eligible inventory. The maximum borrowing availability under the factoring agreement, based on a borrowing base formula, remained \$40 million. In connection with this amendment, we granted GMAC a lien on certain of our inventory located in the United States. A total of \$3.0 million was outstanding under the GMAC facility at September 30, 2005 with respect to collateralized inventory.

The credit facility with GMAC and the credit facility with UPS carry cross-default clauses. A breach of a financial covenant set by GMAC or UPS constitutes an event of default under the other credit facility, entitling both financial institutions to demand payment in full of all outstanding amounts under their respective debt and credit facilities.

The amount we can borrow under the new factoring facility with GMAC is determined based on a defined borrowing base formula related to eligible accounts receivable. A significant decrease in eligible accounts receivable due to the aging of receivables, can have an adverse effect on our borrowing capabilities under our credit facility, which may adversely affect the adequacy of our working capital. In addition, we have typically experienced seasonal fluctuations in sales volume. These seasonal fluctuations result in sales volume decreases in the first and fourth quarters of each year due to the seasonal fluctuations experienced by the majority of our customers. During these quarters, borrowing availability under our credit facility may decrease as a result of decrease in eligible accounts receivables generated from our sales.

On December 14, 2004, we completed a \$10 million financing through the issuance of 6% Secured Convertible Debentures ("Debentures") and warrants to purchase up to 1,250,000 shares of our common stock. Prior to maturity, the investors may convert the Debentures into shares of our common stock at a price of \$2.00 per share. The warrants have a term of five years and an exercise price of \$2.50 per share. The Debentures bear interest at a rate of 6% per annum and have a term of three years. We may elect to pay interest on the Debentures in shares of our common stock if certain conditions are met, including a minimum market price and trading volume for our common stock. The Debentures contain customary events of default and permit the holders thereof to accelerate the maturity if the full principal amount together with interest and other amounts owing upon the occurrence of such events of default. The Debentures are secured by a subordinated lien on certain of our accounts receivable and related assets.

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The placement agent in the financing, received compensation for its services in the amount of

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\$620,000 in cash and issuance of five year warrants to purchase up to 200,000 shares of our common stock at an exercise price of \$2.50 per share.

In June 2005, holders of our Debentures converted an aggregate of \$2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of \$820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of \$2.00 per share. Debt discount of \$248,000 related to the intrinsic value of the conversion option of \$804,000 was expensed upon the conversion. Of the \$620,000 financing cost paid to the placement agent, \$191,000 was expensed upon the conversion. The intrinsic value of the conversion option, and the value of the warrant amortized in the first nine months of 2005 was \$355,000. Total deferred financing cost amortized in the first nine months of 2005 was \$142,000. Total interest paid to the holders of the Debentures in the first nine months of 2005 was \$435,000. As of September 30, 2005, \$5.8 million, net of \$1.1 million of debt discount, remained outstanding under the Debentures.

On February 14, 2005, we borrowed \$5.0 million from Max Azria, which amount bore interest at the rate of 4% per annum and was payable in weekly installments of \$250,000 beginning on February 28, 2005. This was an unsecured loan. As of September 30, 2005, \$0 remained outstanding under this loan. In early August 2005, we repaid the loan in its entirety.

We had two equipment loans outstanding at September 30, 2005 totaling \$66,000 bearing interest at 6% payable in installments through 2009.

From time to time, we open letters of credit under an uncommitted line of credit from Aurora Capital Associates who issues these letters of credits out of Israeli Discount Bank. As of September 30, 2005, \$1.0 million was outstanding under this facility and \$5.1 million of letters of credit were open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

We have financed our operations from our cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt (including debt to or arranged by vendors of equipment purchased for our Mexican twill and production facility), the proceeds from the exercise of stock options and from time to time shareholder advances. Our short-term funding relies very heavily on our major customers, banks, suppliers and major shareholders. From time to time, we have had temporary over-advances from our banks. Any withdrawal of support from these parties will have serious consequences on our liquidity.

From time to time in the past, we borrowed funds from, and advanced funds to, certain officers and principal shareholders, including Gerard Guez and Todd Kay. See disclosure under "-Related Party Transactions" below.

The Internal Revenue Service has proposed adjustments to our Federal income tax returns to increase our income tax payable for the years ended December 31, 1996 through 2001. This adjustment would also result in additional state taxes and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of

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approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and, in particular, cash flow. We may not have an adequate cash reserve to pay the final adjustments resulting from the IRS examination. As a result, we may be required to arrange for payments over time or raise additional capital in order to meet these obligations. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements under the caption "Income Taxes." The maximum amount of loss in excess of the amount accrued in the financial statements is \$12.6 million. We do not believe that the adjustments, if any, arising from the IRS examination, will result in an additional income tax liability beyond what is recorded in the accompanying consolidated balance sheets.

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We may seek to finance future capital investment programs through various methods, including, but not limited to, borrowings under our bank credit facilities, issuance of long-term debt, sales of equity securities, leases and long-term financing provided by the sellers of facilities or the suppliers of certain equipment used in such facilities. To date, there is no plan for any major capital expenditure.

We do not believe that the moderate levels of inflation in the United States in the last three years have had a significant effect on net sales or profitability.

### RELATED PARTY TRANSACTIONS

We lease our principal offices and warehouse located in Los Angeles, California from GET and office space in Hong Kong from Lynx International Limited. GET and Lynx International Limited are each owned by Gerard Guez, our Chairman of the Board of Directors, and Todd Kay, our Vice Chairman of the Board of Directors. We believe, at the time the leases were entered into, the rents on these properties were comparable to then prevailing market rents. The lease with Lynx International Limited for our Hong Kong facility expires on December 31, 2005. We are currently leasing our Los Angeles facility from GET on a month-to-month basis. We paid \$255,000 and \$332,000 in the three months ended September 30, 2005 and 2004, respectively, for office and warehouse facilities. We paid \$764,000 and \$996,000 in the nine months ended September 30, 2005 and 2004, respectively, for office and warehouse facilities.

In August 2004, through Tarrant Mexico, S. de R.L. de C.V., our majority owned and controlled subsidiary in Mexico, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, which agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates in October 2003, for an aggregate purchase price consisting of: a) \$105,400 in cash and \$3,910,000 by delivery of unsecured promissory notes bearing interest at 5.5% per annum; and b) \$40,204,000, by delivery of secured promissory notes bearing interest at 4.5% per annum, maturing on December 31, 2005 and every year thereafter until December 31, 2014. The secured promissory notes are payable in

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partial or total amounts anytime prior to the maturity of each note. Included in the \$44.1 million notes receivable - related party on the accompanying balance sheet as of September 30, 2005 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, \$5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased \$2.3 million and \$1.1 million of fabric from Acabados y Terminados in the three months ended September 30, 2005 and 2004, respectively. We purchased \$4.1 million and \$5.3 million of fabric from Acabados y Terminados in the nine months ended September 30, 2005 and 2004, respectively. Net amount due from these parties as of September 30, 2005 was \$238,000.

From time to time in the past, we borrowed funds from, and advanced funds to, Mr. Guez. The greatest outstanding balance of such advances to Mr. Guez in the third quarter of 2005 was approximately \$2,352,000. Mr. Guez paid our expenses of approximately \$87,000 and \$98,000 for the three months ended September 30, 2005 and 2004, respectively, which amounts were applied to reduce accrued interest and principle on Mr. Guez's loan. Mr. Guez paid expenses on our behalf of approximately \$165,000 and \$278,000 for the nine months ended September 30, 2005 and 2004, respectively, which amounts were applied to reduce accrued interest and principal on Mr. Guez's loan. The balance of \$2.3 million is payable on demand and has been shown as reductions to shareholders' equity as of September 30, 2005. All advances to, and borrowings from, Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$45,000 and \$92,000 for the three months ended September 30, 2005 and 2004, respectively. Total interest paid by Mr. Guez was \$321,000 and \$299,000 for the nine months ended September 30, 2005 and 2004, respectively. These amounts included fuel and related expenses incurred by 477 Aviation, LLC, a company owned by Mr. Guez, when our executives used this company's aircraft for business purposes. Since the enactment of the Sarbanes-Oxley Act in 2002, no further personal loans (or amendments to existing loans) have been or will be made to our executive officers or directors.

On July 1, 2001, we formed an entity to jointly market, share certain risks and achieve economies of scale with Azteca Production International, Inc. ("Azteca"), called United Apparel Ventures, LLC ("UAV"). Azteca is owned by Hubert Guez, the brother of Gerard Guez, our Chairman. This entity was created to coordinate the production of apparel for a single customer of our branded business. UAV is owned 50.1% by Tag Mex, Inc., our wholly owned subsidiary, and 49.9% by Azteca. Results of the operation of UAV have been consolidated into our

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results since July 2001 with the minority partner's share of all gains and losses eliminated through the minority interest line in our financial statements. Due to the restructuring of our Mexico operations, we discontinued manufacturing for UAV customers in the second quarter of 2004. Two and one half percent of gross sales as management fees were paid to each of the members of UAV, per the operating agreement. The amount paid to Azteca, the minority member of UAV, totaled \$0 and \$0 in the three months ended September 30, 2005 and 2004, respectively. We purchased \$0 and \$2.0 million of finished goods and service from Azteca and its affiliates in the three months ended September 30, 2005 and 2004, respectively. We purchased \$135,000 and \$7.5 million of finished goods and service from Azteca and its affiliates in the nine months ended September 30, 2005 and 2004, respectively. Our total sales of fabric and service to Azteca in the three months ended September 30, 2005 and 2004 were \$0. Our total sales of fabric and service to Azteca in the nine months ended September 30, 2005 and

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2004 were \$63,000 and \$1.0 million, respectively.

Commencing in June 2003, UAV began selling to Seven Licensing Company, LLC ("Seven Licensing"), jeans wear bearing the brand "Seven7", which was ultimately purchased by Express. Seven Licensing is beneficially owned by Gerard Guez. In the third quarter of 2004, in order to strengthen our own private brand business, we decided to discontinue sourcing for Seven7. Total sales to Seven7 in the three months ended September 30, 2005 and 2004 were \$0 and \$42,000, respectively. Total sales to Seven7 in the nine months ended September 30, 2005 and 2004 were \$0 and \$3.4 million, respectively.

At December 31, 2004, Messrs. Guez and Kay beneficially owned 961,000 and 1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc. ("Tag-It"), collectively representing 10.8% of Tag-It Pacific's common stock at December 31, 2004. Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Commencing in 1998, Tag-It assumed the responsibility for managing and sourcing all trim and packaging used in connection with products manufactured by or on our behalf in Mexico. Due to the restructuring of our Mexico operations, Tag-It no longer manages our trim and packaging requirements. We purchased \$20,000 and \$465,000 of trim inventory from Tag-It in the three months ended September 30, 2005 and 2004, respectively. We purchased \$55,000 and \$1.2 million of trim inventory from Tag-It in the nine months ended September 30, 2005 and 2004, respectively. From time to time we have guaranteed the indebtedness of Tag-It for the purchase of trim on our behalf. See Note 7 of the "Notes to Consolidated Financial Statements."

We believe the each of the transactions described above has been entered into on terms no less favorable to us than could have been obtained from unaffiliated third parties. We have adopted a policy that any transactions between us and any of our affiliates or related parties, including our executive officers, directors, the family members of those individuals and any of their affiliates, must (i) be approved by a majority of the members of the Board of Directors and by a majority of the disinterested members of the Board of Directors and (ii) be on terms no less favorable to us than could be obtained from unaffiliated third parties.

### FACTORS THAT MAY AFFECT FUTURE RESULTS

This Quarterly Report on Form 10-Q contains forward-looking statements, which are subject to a variety of risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth below.

### RISKS RELATED TO OUR BUSINESS

WE DEPEND ON A GROUP OF KEY CUSTOMERS FOR A SIGNIFICANT PORTION OF OUR SALES. A SIGNIFICANT ADVERSE CHANGE IN A CUSTOMER RELATIONSHIP OR IN A CUSTOMER'S FINANCIAL POSITION COULD HARM OUR BUSINESS AND FINANCIAL CONDITION.

Kohl's accounted for 13.5% and 16.6% of our net sales for the first nine months of 2005 and 2004, respectively. Mervyn's accounted for 9.8% and 16.5% of our net sales for the first nine months of 2005 and 2004, respectively. Lerner New York accounted for 9.3% and 13.0% of our net sales for the first nine months of 2005 and 2004, respectively. Affiliated department stores owned by Federated Department Stores accounted for approximately 11.5% and 8.9% of our net sales for the first nine months of 2005 and 2004, respectively. Wal-Mart accounted for approximately 12.0% and 7.0% of our net sales for the first nine months of 2005 and 2004, respectively. We believe that consolidation in the retail industry has centralized purchasing decisions and given customers greater leverage over suppliers like us, and we expect this trend to continue. If this consolidation

continues, our net sales and results of operations may be increasingly sensitive to deterioration in the financial condition of, or other adverse developments with, one or more of our customers.

While we have long-standing customer relationships, we generally do not have long-term contracts with them. Purchases generally occur on an order-by-order basis, and relationships exist as long as there is a perceived benefit to both parties. A decision by a major customer, whether motivated by competitive considerations, financial difficulties, and economic conditions or otherwise, to decrease its purchases from us or to change its manner of doing business with us, could adversely affect our business and financial condition. In addition, during recent years, various retailers, including some of our customers, have experienced significant changes and difficulties, including consolidation of ownership, increased centralization of purchasing decisions, restructurings, bankruptcies and liquidations.

These and other financial problems of some of our retailers, as well as general weakness in the retail environment, increase the risk of extending credit to these retailers. A significant adverse change in a customer relationship or in a customer's financial position could cause us to limit or discontinue business with that customer, require us to assume more credit risk relating to that customer's receivables, limit our ability to collect amounts related to previous purchases by that customer, or result in required prepayment of our receivables securitization arrangements, all of which could harm our business and financial condition.

#### FAILURE OF THE TRANSPORTATION INFRASTRUCTURE TO MOVE SEA FREIGHT IN ACCEPTABLE TIME FRAMES COULD ADVERSELY AFFECT OUR BUSINESS.

Because the bulk of our freight is designed to move through the West Coast ports in predictable time frames, we are at risk of cancellations and penalties when those ports operate inefficiently creating delays in delivery. We experienced such delays from June 2004 until November 2004, and we may experience similar delays in the future especially during peak seasons. There can be no assurances of, and we have no control over a return to timely deliveries. Unpredictable timing for shipping may cause us to utilize air freight or may result in customer penalties for late delivery, any of which could reduce our operating margins and adversely effect our results of operations.

#### FAILURE TO MANAGE OUR GROWTH AND EXPANSION COULD IMPAIR OUR BUSINESS.

Since our inception, we have experienced periods of rapid growth. No assurance can be given that we will be successful in maintaining or increasing our sales in the future. Any future growth in sales will require additional working capital and may place a significant strain on our management, management information systems, inventory management, sourcing capability, distribution facilities and receivables management. Any disruption in our order processing, sourcing or distribution systems could cause orders to be shipped late, and under industry practices, retailers generally can cancel orders or refuse to accept goods due to late shipment. Such cancellations and returns would result in a reduction in revenue, increased administrative and shipping costs and a further burden on our distribution facilities.

#### OUR OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY.

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We have experienced, and expect to continue to experience, substantial variations in our net sales and operating results from quarter to quarter. We believe that the factors which influence this variability of quarterly results include the timing of our introduction of new product lines, the level of consumer acceptance of each new product line, general economic and industry conditions that affect consumer spending and retailer purchasing, the availability of manufacturing capacity, the seasonality of the markets in which we participate, the timing of trade shows, the product mix of customer orders, the timing of the placement or cancellation of customer orders, the weather, transportation delays, the occurrence of charge backs in excess of reserves and the timing of expenditures in anticipation of increased sales and actions of competitors. Due to fluctuations in our revenue and operating expenses, we believe that period-to-period comparisons of our results of operations are not a good indication of our future performance. It is possible that in some future quarter or quarters, our operating results will be below the expectations of securities analysts or investors. In that case, our stock price could fluctuate significantly or decline.

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### THE FINANCIAL CONDITION OF OUR CUSTOMERS COULD AFFECT OUR RESULTS OF OPERATIONS.

Certain retailers, including some of our customers, have experienced in the past, and may experience in the future, financial difficulties, which increase the risk of extending credit to such retailers and the risk that financial failure will eliminate a customer entirely. These retailers have attempted to improve their own operating efficiencies by concentrating their purchasing power among a narrowing group of vendors. There can be no assurance that we will remain a preferred vendor for our existing customers. A decrease in business from or loss of a major customer could have a material adverse effect on our results of operations. There can be no assurance that our factor will approve the extension of credit to certain retail customers in the future. If a customer's credit is not approved by the factor, we could assume the collection risk on sales to the customer itself, require that the customer provide a letter of credit, or choose not to make sales to the customer.

### WE DEPEND ON OUR COMPUTER AND COMMUNICATIONS SYSTEMS.

As a multi-national corporation, we rely on our computer and communication network to operate efficiently. Any interruption of this service from power loss, telecommunications failure, weather, natural disasters or any similar event could have a material adverse affect on our business and operations. Additionally, hackers and computer viruses have disrupted operations at many major companies. We may be vulnerable to similar acts of sabotage, which could have a material adverse effect on our business and operations.

### WE MAY REQUIRE ADDITIONAL CAPITAL IN THE FUTURE.

We may not be able to fund our future growth or react to competitive pressures if we lack sufficient funds. Currently, we believe we have sufficient vendor credit, cash on hand and cash available through our bank credit facilities, issuance of long-term debt, proceeds from sale of debt or equity securities, and proceeds from the exercise of stock options to fund existing operations for the foreseeable future. However, in the future we may need to raise additional funds through equity or debt financings or collaborative relationships. This additional funding may not be available or, if available, it may not be available on economically reasonable terms. In addition, any additional funding may result in significant dilution to existing shareholders. If adequate funds are not available, we may be required to curtail our



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operations or obtain funds through collaborative partners that may require us to release material rights to our products.

OUR BUSINESS IS SUBJECT TO RISKS ASSOCIATED WITH IMPORTING PRODUCTS.

Substantially all of our import operations are subject to tariffs imposed on imported products, safeguards and growth targets imposed by trade agreements. In addition, the countries in which our products are manufactured or imported may from time to time impose additional new duties, tariffs or other restrictions on our imports or adversely modify existing restrictions. Adverse changes in these import costs and restrictions, or our suppliers' failure to comply with customs or similar laws, could harm our business. We cannot assure that future trade agreements will not provide our competitors with an advantage over us, or increase our costs, either of which could have an adverse effect on our business and financial condition.

Our operations are also subject to the effects of international trade agreements and regulations such as the North American Free Trade Agreement, and the activities and regulations of the World Trade Organization. Generally, these trade agreements benefit our business by reducing or eliminating the duties assessed on products manufactured in a particular country. However, trade agreements can also impose requirements that adversely affect our business, such as limiting the countries from which we can purchase raw materials and setting duties or restrictions on products that may be imported into the United States from a particular country. In addition, the World Trade Organization may commence a new round of trade negotiations that liberalize textile trade by further eliminating or reducing tariffs. The elimination of quotas on World Trade Organization member countries in 2005 has resulted in explosive growth in textile imports from China, and subsequent safeguard measures including embargo of certain China country of origin products, which has been disruptive, and has a negative impact on margins. Such disruption may continue to affect our products to some extent in the future.

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OUR DEPENDENCE ON INDEPENDENT MANUFACTURERS REDUCES OUR ABILITY TO CONTROL THE MANUFACTURING PROCESS, WHICH COULD HARM OUR SALES, REPUTATION AND OVERALL PROFITABILITY.

We depend on independent contract manufacturers to secure a sufficient supply of raw materials and maintain sufficient manufacturing and shipping capacity in an environment characterized by declining prices, labor shortage, continuing cost pressure and increased demands for product innovation and speed-to-market. This dependence could subject us to difficulty in obtaining timely delivery of products of acceptable quality. In addition, a contractor's failure to ship products to us in a timely manner or to meet the required quality standards could cause us to miss the delivery date requirements of our customers. The failure to make timely deliveries may cause our customers to cancel orders, refuse to accept deliveries, impose non-compliance charges through invoice deductions or other charge-backs, demand reduced prices or reduce future orders, any of which could harm our sales, reputation and overall profitability. We do not have material long-term contracts with any of our independent contractors and any of these contractors may unilaterally terminate their relationship with us at any time. To the extent we are not able to secure or maintain relationships with independent contractors that are able to fulfill our requirements, our business would be harmed.

We have initiated a factory compliance agreement with our suppliers, and monitor our independent contractors' compliance with applicable labor laws,

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but we do not control our contractors or their labor practices. The violation of federal, state or foreign labor laws by one of the our contractors could result in our being subject to fines and our goods that are manufactured in violation of such laws being seized or their sale in interstate commerce being prohibited. From time to time, we have been notified by federal, state or foreign authorities that certain of our contractors are the subject of investigations or have been found to have violated applicable labor laws. To date, we have not been subject to any sanctions that, individually or in the aggregate, have had a material adverse effect on our business, and we are not aware of any facts on which any such sanctions could be based. There can be no assurance, however, that in the future we will not be subject to sanctions as a result of violations of applicable labor laws by our contractors, or that such sanctions will not have a material adverse effect on our business and results of operations. In addition, certain of our customers, require strict compliance by their apparel manufacturers, including us, with applicable labor laws and visit our facilities often. There can be no assurance that the violation of applicable labor laws by one of our contractors will not have a material adverse effect on our relationship with our customers.

OUR BUSINESS IS SUBJECT TO RISKS OF OPERATING IN A FOREIGN COUNTRY AND TRADE RESTRICTIONS.

Approximately 95% of our products sold in the third quarter of 2005 were imported from outside the U.S. We are subject to the risks associated with doing business in foreign countries, including, but not limited to, transportation delays and interruptions, political instability, expropriation, currency fluctuations and the imposition of tariffs, import and export controls, other non-tariff barriers and cultural issues. Any changes in those countries' labor laws and government regulations may have a negative effect on our profitability.

RISK ASSOCIATED WITH OUR INDUSTRY

OUR SALES ARE HEAVILY INFLUENCED BY GENERAL ECONOMIC CYCLES.

Apparel is a cyclical industry that is heavily dependent upon the overall level of consumer spending. Purchases of apparel and related goods tend to be highly correlated with cycles in the disposable income of our consumers. Our customers anticipate and respond to adverse changes in economic conditions and uncertainty by reducing inventories and canceling orders. As a result, any substantial deterioration in general economic conditions, increases in interest rates, acts of war, terrorist or political events that diminish consumer spending and confidence in any of the regions in which we compete, could reduce our sales and adversely affect our business and financial condition.

OUR BUSINESS IS HIGHLY COMPETITIVE AND DEPENDS ON CONSUMER SPENDING PATTERNS.

The apparel industry is highly competitive. We face a variety of competitive challenges including:

- o anticipating and quickly responding to changing consumer demands;

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- o developing innovative, high-quality products in sizes, colors and styles that appeal to consumers of varying age groups and tastes;

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- o competitively pricing our products and achieving customer perception of value; and
- o the need to provide strong and effective marketing support.

WE MUST SUCCESSFULLY GAUGE FASHION TRENDS AND CHANGING CONSUMER PREFERENCES TO SUCCEED.

Our success is largely dependent upon our ability to gauge the fashion tastes of our customers and to provide merchandise that satisfies retail and customer demand in a timely manner. The apparel business fluctuates according to changes in consumer preferences dictated in part by fashion and season. To the extent we misjudge the market for our products, our sales may be adversely affected. Our ability to anticipate and effectively respond to changing fashion trends depends in part on our ability to attract and retain key personnel in our design, merchandising and marketing staff. Competition for these personnel is intense, and we cannot be sure that we will be able to attract and retain a sufficient number of qualified personnel in future periods.

OUR BUSINESS IS SUBJECT TO SEASONAL TRENDS.

Historically, our operating results have been subject to seasonal trends when measured on a quarterly basis. This trend is dependent on numerous factors, including the markets in which we operate, holiday seasons, consumer demand, climate, economic conditions and numerous other factors beyond our control. There can be no assurance that our historic operating patterns will continue in future periods as we cannot influence or forecast many of these factors.

OTHER RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK

THE ULTIMATE RESOLUTION OF THE INTERNAL REVENUE SERVICE'S EXAMINATION OF OUR TAX RETURNS MAY REQUIRE US TO INCUR AN EXPENSE BEYOND WHAT HAS BEEN RESERVED FOR ON OUR BALANCE SHEET OR MAKE CASH PAYMENTS BEYOND WHAT WE ARE THEN ABLE TO PAY.

In January 2004, the Internal Revenue Service proposed adjustments to increase our federal income tax payable for the years ended December 31, 1996 through 2001. This adjustment would also result in additional state taxes, penalties and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and cash flow. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements. The maximum amount of loss in excess of the amount accrued in the financial statements is \$12.6 million. If the amount of any actual liability, however, exceeds our reserves, we would experience an immediate adverse earnings impact in the amount of such additional liability, which could be material. Additionally, we anticipate that the ultimate resolution of these matters will require that we make significant cash payments to the taxing authorities. Presently we do not have sufficient cash or borrowing ability to make any future payments that may be required. No assurance can be given that we will have sufficient surplus cash from operations to make the required payments. Additionally, any cash used for these purposes will not be available for other corporate purposes, which could have a material adverse effect on our financial condition and results of operations.

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INSIDERS OWN A SIGNIFICANT PORTION OF OUR COMMON STOCK, WHICH COULD LIMIT OUR SHAREHOLDERS' ABILITY TO INFLUENCE THE OUTCOME OF KEY TRANSACTIONS.

As of September 30, 2005, our executive officers and directors and their affiliates owned approximately 42.8% of the outstanding shares of our common stock. Gerard Guez, our Chairman, and Todd Kay, our Vice Chairman, alone own approximately 33.1% and 8.4%, respectively, of the outstanding shares of our common stock

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at September 30, 2005. Accordingly, our executive officers and directors have the ability to affect the outcome of, or exert considerable influence over, all matters requiring shareholder approval, including the election and removal of directors and any change in control. This concentration of ownership of our common stock could have the effect of delaying or preventing a change of control of us or otherwise discouraging or preventing a potential acquirer from attempting to obtain control of us. This, in turn, could have a negative effect on the market price of our common stock. It could also prevent our shareholders from realizing a premium over the market prices for their shares of common stock.

WE HAVE ADOPTED A NUMBER OF ANTI-TAKEOVER MEASURES THAT MAY DEPRESS THE PRICE OF OUR COMMON STOCK.

Our shareholders rights plan, our ability to issue additional shares of preferred stock and some provisions of our articles of incorporation and bylaws could make it more difficult for a third party to make an unsolicited takeover attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price without approval of our board of directors.

OUR STOCK PRICE HAS BEEN VOLATILE.

Our common stock is quoted on the NASDAQ National Market System, and there can be substantial volatility in the market price of our common stock. The market price of our common stock has been, and is likely to continue to be, subject to significant fluctuations due to a variety of factors, including quarterly variations in operating results, operating results which vary from the expectations of securities analysts and investors, changes in financial estimates, changes in market valuations of competitors, announcements by us or our competitors of a material nature, loss of one or more customers, additions or departures of key personnel, future sales of common stock and stock market price and volume fluctuations. In addition, general political and economic conditions such as a recession, or interest rate or currency rate fluctuations may adversely affect the market price of our common stock.

In addition, the stock market in general has experienced extreme price and volume fluctuations that have affected the market price of our common stock. Often, price fluctuations are unrelated to operating performance of the specific companies whose stock is affected. In the past, following periods of volatility in the market price of a company's stock, securities class action litigation has occurred against the issuing company. If we were subject to this type of litigation in the future, we could incur substantial costs and a diversion of our management's attention and resources, each of which could have a material adverse effect on our revenue and earnings. Any adverse determination in this type of litigation could also subject us to significant liabilities.

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ABSENCE OF DIVIDENDS COULD REDUCE OUR ATTRACTIVENESS TO YOU.

Some investors favor companies that pay dividends, particularly in general downturns in the stock market. We have not declared or paid any cash dividends on our common stock. We currently intend to retain any future earnings for funding growth, and we do not currently anticipate paying cash dividends on our common stock in the foreseeable future. Additionally, we cannot pay dividends on our common stock unless the terms of our bank credit facilities and outstanding preferred stock, if any, permit the payment of dividends on our common stock. Because we may not pay dividends, your return on this investment likely depends on your selling our stock at a profit.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

**FOREIGN CURRENCY RISK.** Our earnings are affected by fluctuations in the value of the U.S. dollar as compared to foreign currencies as a result of doing business in foreign jurisdictions. As a result, we bear the risk of exchange rate gains and losses that may result in the future.

**INTEREST RATE RISK.** Because our obligations under our various credit agreements bear interest at floating rates (primarily LIBOR rates), we are sensitive to changes in prevailing interest rates. Any major increase or decrease in market interest rates that affect our financial instruments would have a material impact on earning or cash flows during the next fiscal year.

Our interest expense is sensitive to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect interest paid on our debt. A majority of our credit facilities are at variable rates.

### ITEM 4. CONTROLS AND PROCEDURES.

#### EVALUATION OF CONTROLS AND PROCEDURES

Members of the company's management, including our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as defined by paragraph (e) of Exchange Act Rules 13a-15 or 15d-15, as of September 30, 2005, the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

#### CHANGES IN CONTROLS AND PROCEDURES

During the third quarter of 2005 there were no significant changes in our internal controls or in other factors known to the Chief Executive Officer or the Chief Financial Officer that materially affected, or are reasonably likely to materially effect, our internal control over financial reporting.

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## PART II -- OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS.

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From time to time, we are involved in various routine legal proceedings incidental to the conduct of our business. Our management does not believe that any of these legal proceedings will have a material adverse impact on our business, financial condition or results of operations, either due to the nature of the claims, or because our management believes that such claims should not exceed the limits of the our insurance coverage.

### ITEM 6. EXHIBITS.

EXHIBIT NUMBER -----	DESCRIPTION -----
10.16.20	Second Deed of Variation to Loan Agreement effective as of July 29, 2005 among Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited and UPS Capital Global Trade Finance Corporation.
10.16.21	Thirteenth Deed of Variation to Syndicated Letter of Credit Facility effective as of July 29, 2005 among Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited and UPS Capital Global Trade Finance Corporation.
10.16.22	Fourteenth Deed of Variation to Syndicated Letter of Credit Facility effective as of August 31, 2005 among Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited and UPS Capital Global Trade Finance Corporation.
10.31	Employment Agreement, dated September 16, 2005, between Tarrant Company Limited and Henry Chu.
10.44	Tenancy Agreement, dated July 1, 2005, between Tarrant Company Limited and Lynx International Limited.
31.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
31.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
32.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
32.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.

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### 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.

TARRANT APPAREL GROUP

Date: November 14, 2005

By: /s/ Corazon Reyes

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Corazon Reyes,

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Chief Financial Officer

Date: November 14, 2005

By: /s/ Barry Aved

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Barry Aved,  
Chief Executive Officer