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TARRANT APPAREL GROUP  
Form 10-Q  
November 14, 2006

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, 2006

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

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 a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares of Common Stock of the Registrant outstanding as of November 10, 2006: 30,543,763.

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TARRANT APPAREL GROUP  
FORM 10-Q  
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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

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the factors that could materially affect the accuracy of Tarrant's 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,<br>2006 | DECEMBER 31,<br>2005 |
|---|-----------------------|----------------------|
|   | -----                 | -----                |
|   | (Unaudited)           |                      |
| <b>ASSETS</b>   |                       |                      |
| Current assets:   |                       |                      |
| Cash and cash equivalents .....   | \$ 976,481            | \$ 1,641,768         |
| Accounts receivable, net .....  | 46,175,909            | 54,598,443           |
| Due from related parties .....  | 3,918,287             | 3,100,928            |
| Inventory .....   | 20,455,702            | 31,628,960           |
| Temporary quota rights .....  | 111,207               | --                   |
| Current portion of notes receivable -- related parties ...  | --                    | 5,139,387            |
| Prepaid expenses .....  | 1,219,895             | 1,292,441            |
| Prepaid royalties .....   | --                    | 1,123,531            |
| Income taxes receivable .....   | 25,468                | 25,468               |
|   | -----                 | -----                |
| Total current assets .....  | 72,882,949            | 98,550,926           |
| Property and equipment, net of \$11.0 million and \$10.8 million accumulated depreciation at September 30, 2006 and December 31, 2005, respectively ..... | 1,477,101             | 1,702,840            |
| Notes receivable - related parties, net of current portion, and net of \$27.1 million reserve at September 30, 2006 .....                                 | 14,000,000            | 36,268,446           |
| Due from related parties .....  | 2,213,416             | 2,994,945            |
| Equity method investment .....  | 2,174,380             | 2,138,865            |
| Deferred financing cost, net of \$1.5 million and \$711,250 accumulated amortization at September 30, 2006 and December 31, 2005, respectively .....      | 2,654,952             | 838,786              |
| Other assets .....  | 507,379               | 164,564              |
| Goodwill .....  | 8,582,845             | 8,582,845            |
|   | -----                 | -----                |
| Total assets .....  | \$ 104,493,022        | \$ 151,242,217       |

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| LIABILITIES AND SHAREHOLDERS' EQUITY  |                |                |
|---|----------------|----------------|
| Current liabilities:  |                |                |
| Short-term bank borrowings .....  | \$ 12,534,937  | \$ 13,833,532  |
| Accounts payable .....  | 18,195,022     | 33,278,959     |
| Accrued expenses .....  | 9,777,354      | 9,503,806      |
| Income taxes .....  | 17,035,409     | 16,828,538     |
| Current portion of long-term obligations and factoring<br>arrangement .....   | 19,769,030     | 36,109,699     |
|   | -----          | -----          |
| Total current liabilities .....   | 77,311,752     | 109,554,534    |
| Term loan, net .....  | 10,941,948     | --             |
| Other long-term obligations .....   | 26,380         | 239,935        |
| Convertible debentures, net .....   | --             | 5,965,098      |
| Deferred tax liabilities .....  | 39,025         | 47,098         |
|   | -----          | -----          |
| Total liabilities .....   | 88,319,105     | 115,806,665    |
| Minority interest in consolidated subsidiary .....  | 57,469         | 75,241         |
| Commitment and Contingencies  |                |                |
| Shareholders' equity:   |                |                |
| Preferred stock, 2,000,000 shares authorized; no shares<br>at September 30, 2006 and December 31, 2005 issued<br>and outstanding .....  | --             | --             |
| Common stock, no par value, 100,000,000 shares authorized;<br>30,543,763 shares at September 30, 2006 and 30,553,763<br>shares at December 31, 2005 issued and outstanding .... | 114,977,465    | 114,977,465    |
| Warrants to purchase common stock .....   | 7,314,239      | 2,846,833      |
| Contributed capital .....   | 10,101,151     | 10,004,331     |
| Accumulated deficit .....   | (114,094,373)  | (90,189,615)   |
| Notes receivable from officer/shareholder .....   | (2,182,034)    | (2,278,703)    |
|   | -----          | -----          |
| Total shareholders' equity .....  | 16,116,448     | 35,360,311     |
|   | -----          | -----          |
| Total liabilities and shareholders' equity .....  | \$ 104,493,022 | \$ 151,242,217 |
|   | =====          | =====          |

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

TARRANT APPAREL GROUP  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

| THREE MONTHS ENDED<br>SEPTEMBER 30, |      | NINE MONTH<br>SEPTEMBER |
|-------------------------------------|------|-------------------------|
| -----                               |      | -----                   |
| 2006                                | 2005 | 2006                    |

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|  |                 |               |                 |
|--|-----------------|---------------|-----------------|
|  | -----           | -----         | -----           |
| Net sales .....  | \$ 54,645,223   | \$ 69,566,080 | \$ 174,989,008  |
| Cost of sales .....  | 42,844,174      | 55,020,926    | 138,006,628     |
|  | -----           | -----         | -----           |
| Gross profit .....   | 11,801,049      | 14,545,154    | 36,982,380      |
| Selling and distribution expenses .....                      | 2,568,038       | 2,846,445     | 8,295,815       |
| General and administrative expenses .....                    | 6,551,393       | 7,398,722     | 19,914,629      |
| Royalty expenses .....                                       | 263,583         | 1,288,634     | 2,099,392       |
| Loss on notes receivable - related parties .                 | 27,137,297      | --            | 27,137,297      |
|  | -----           | -----         | -----           |
| Income (loss) from operations .....                          | (24,719,262)    | 3,011,353     | (20,464,753)    |
| Interest expense .....                                       | (1,562,426)     | (1,301,271)   | (4,696,279)     |
| Interest income .....  | 165,399         | 505,913       | 1,131,601       |
| Interest in income (loss) of equity method<br>investee ..... | (7,307)         | 129,587       | 103,015         |
| Other income .....   | 109,093         | 38,589        | 233,466         |
| Adjustment to fair value of derivative .....                 | 729,394         | --            | 511,087         |
| Other expense .....  | --              | (228)         | (400,000)       |
| Minority interest in consolidated subsidiary                 | 13,641          | (163,576)     | 17,772          |
|  | -----           | -----         | -----           |
| Income (loss) before provision for income<br>taxes .....     | (25,271,468)    | 2,220,367     | (23,564,091)    |
| Provision for income taxes .....                             | 80,946          | 517,950       | 340,667         |
|  | -----           | -----         | -----           |
| Net income (loss) .....                                      | \$ (25,352,414) | \$ 1,702,417  | \$ (23,904,758) |
|  | =====           | =====         | =====           |
| Net income (loss) per share:                                 |                 |               |                 |
| Basic .....  | \$ (0.83)       | \$ 0.06       | \$ (0.78)       |
|  | =====           | =====         | =====           |
| Diluted .....  | \$ (0.83)       | \$ 0.06       | \$ (0.78)       |
|  | =====           | =====         | =====           |
| Weighted average common and common<br>equivalent shares:     |                 |               |                 |
| Basic .....  | 30,543,763      | 30,365,502    | 30,546,217      |
|  | =====           | =====         | =====           |
| Diluted .....  | 30,543,763      | 30,785,797    | 30,546,217      |
|  | =====           | =====         | =====           |

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

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|  | NINE MONTHS ENDED SEPTEMBER 30, |               |
|--|---------------------------------|---------------|
|  | 2006                            | 2005          |
|  | -----                           | -----         |
| Operating activities:  |                                 |               |
| Net income (loss) .....  | \$ (23,904,758)                 | \$ 2,467,436  |
| Adjustments to reconcile net income to net cash provided by<br>(used in) operating activities: |                                 |               |
| Deferred taxes .....   | (8,073)                         | (61,551)      |
| Depreciation and amortization .....  | 2,383,897                       | 1,738,937     |
| Adjustment to fair value of derivative .....   | (511,087)                       | --            |
| Loss on notes receivable - related parties .....   | 27,137,297                      | --            |
| Compensation expense related to stock option .....   | --                              | 38,740        |
| Provision for returns and discounts .....  | 318,208                         | 372,805       |
| Gain on sale of fixed assets .....   | (2,054)                         | (113,968)     |
| Interest in income of equity method investee .....   | (103,015)                       | (475,947)     |
| Minority interest in consolidated subsidiary .....   | (17,772)                        | 163,577       |
| Stock-based compensation .....   | 96,820                          | --            |
| Changes in operating assets and liabilities:   |                                 |               |
| Accounts receivable .....  | 7,288,752                       | (27,473,378)  |
| Due to/from related parties .....  | (35,830)                        | 1,982,152     |
| Inventory .....  | 11,173,258                      | (6,819,037)   |
| Temporary quota rights .....   | (111,207)                       | --            |
| Prepaid expenses .....   | 1,196,077                       | 54,471        |
| Accounts payable .....   | (15,083,937)                    | 3,634,123     |
| Accrued expenses and income tax payable .....  | 480,420                         | 1,689,190     |
|  | -----                           | -----         |
| Net cash provided by (used in) operating activities ..   | 10,296,996                      | (22,802,450)  |
| Investing activities:  |                                 |               |
| Purchase of fixed assets .....   | (130,177)                       | (452,930)     |
| Proceeds from sale of fixed assets .....   | 4,707                           | 119,506       |
| Distribution from equity method investee .....   | 67,500                          | 216,000       |
| Collection on notes receivable, related parties .....  | 1,086,111                       | 977,500       |
| Collection of advances from shareholders/officers .....  | 96,669                          | 2,456,334     |
|  | -----                           | -----         |
| Net cash provided by investing activities .....  | 1,124,810                       | 3,316,410     |
| Financing activities:  |                                 |               |
| Short-term bank borrowings, net .....  | (1,298,595)                     | (2,536,215)   |
| Proceeds from long-term obligations .....  | 183,669,591                     | 167,099,510   |
| Payment of financing costs .....   | (2,821,647)                     | --            |
| Repayments of borrowings from convertible debentures ...                                       | (6,912,626)                     | --            |
| Payment of long-term obligations and bank borrowings ...                                       | (184,723,816)                   | (144,655,258) |
|  | -----                           | -----         |
| Net cash (used in) provided by financing activities ..   | (12,087,093)                    | 19,908,037    |
|  | -----                           | -----         |
| Increase (decrease) in cash and cash equivalents .....   | (665,287)                       | 421,997       |
| Cash and cash equivalents at beginning of period .....   | 1,641,768                       | 1,214,944     |
|  | -----                           | -----         |
| Cash and cash equivalents at end of period .....   | \$ 976,481                      | \$ 1,636,941  |
|  | =====                           | =====         |

The accompanying notes are an integral part of these consolidated financial

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statements

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## TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

#### 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., Asia, Mexico, and Luxembourg. At September 30, 2006, 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 and Interim Chief Executive Officer, 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. See Note 14 of the "Notes to Consolidated Financial Statements".

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, 2005 is derived from

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audited financial statements which are included in our Annual Report on Form 10-K for the year ended December 31, 2005, 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 significant inter-company transactions and balances have been eliminated from the consolidated financial statements.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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) notes receivable - related parties reserve, (iv) valuation of long lived and intangible assets and goodwill, (v) income taxes, and (vi) stock options valuation. Actual results could differ from those estimates.

#### ROYALTY EXPENSES

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. Some of these agreements include minimum royalties. See Note 15 of the "Notes to Consolidated Financial Statements" regarding various agreements we have entered into.

#### DEFERRED RENT PROVISION

When a lease requires fixed escalation of the minimum lease payments, rental expense is recognized on a straight line basis over the initial term of the lease, and the difference between the average rental amount charged to expense and amounts payable under the lease is included in deferred amount. As of September 30, 2006, deferred rent of \$71,000 was recorded under accrued expense in our consolidated financial statements.

#### VALUATION OF DERIVATIVE INSTRUMENTS

Statements of Financial Accounting Standards ("SFAS") No. 133



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"Accounting for Derivative Instruments and Hedging Activities" requires measurement of certain derivative instruments at their fair value for accounting purposes. In determining the appropriate fair value, we use the Black-Scholes-Merton Option Pricing Formula (the "Black-Scholes Model"). Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in consolidated statements of operations as adjustments to fair value of derivatives.

### STOCK-BASED COMPENSATION

On January 1, 2006, we adopted Statements of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 107 ("SAB 107") relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our financial statements as of and for the nine months ended September 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) during the three months and nine months ended September 30, 2006 was \$90,000 and \$97,000. Basic and dilutive earnings per share for the three months and nine months ended September 30, 2006 were not affected by the additional stock-based compensation recognized.

The fair value of each option granted to employees and directors is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2006 and 2005: weighted-average volatility factors of the expected market price of our common stock of 0.70 and 0.55 for the three months ended September 30, 2006 and 2005, weighted-average risk-free interest rates of 5.075% and 4% for the three months ended September 30, 2006 and 2005, dividend yield of 0% for the three months

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### TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

ended September 30, 2006 and 2005, and weighted-average expected life of the options of 6.25 years and 4 years for the three months ended September 30, 2006 and 2005.

The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based payment awards granted under our stock option plans for the three and nine months ended September 30, 2005:

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|   | THREE MONTHS<br>ENDED<br>SEPTEMBER 30,<br>2005 | NINE MONTHS<br>ENDED<br>SEPTEMBER 30,<br>2005 |
|---|--|---|
|   | -----  | -----   |
| Net income as reported .....  | \$ 1,702,417                                   | \$ 2,467,436                                  |
| Add stock-based employee compensation charges<br>reported in net income .....           | 38,740   | 38,740  |
| Pro forma compensation expense, net of tax .....  | (3,248,221)                                    | (4,298,193)                                   |
|   | -----  | -----   |
| Pro forma net loss .....  | \$ (1,507,064)                                 | \$ (1,792,017)                                |
|   | =====  | =====   |
| Net income per share as reported - Basic .....  | \$ 0.06  | \$ 0.08                                       |
| Add stock-based employee compensation charges<br>reported in net income--Basic .....    | --   | --  |
| Pro forma compensation expense per share - Basic  | (0.11)   | (0.14)  |
|   | -----  | -----   |
| Pro forma net loss per share - Basic .....  | \$ (0.05)                                      | \$ (0.06)                                     |
|   | =====  | =====   |
| Net income per share as reported -Diluted .....   | \$ 0.06  | \$ 0.08                                       |
| Add stock-based employee compensation charges<br>reported in net income - Diluted ..... | --   | --  |
| Pro forma compensation expense per share -Diluted                                       | (0.11)   | (0.14)  |
|   | -----  | -----   |
| Pro forma net loss per share -Diluted .....   | \$ (0.05)                                      | \$ (0.06)                                     |
|   | =====  | =====   |

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our consolidated statements of operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based payment awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation expense had been recognized in our consolidated statements of operations for awards to employees and directors because the exercise price of our stock options equaled the fair market value of the underlying stock at the date of grant.

On September 23, 2005, the Board of Directors approved the acceleration of vesting of all our unvested stock options, including those not issued under the plan; see Note 3 of the "Notes to Consolidated Financial Statements." 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. As a result, there were no stock options granted prior to, but not yet vested as of January 1, 2006. There was no stock-based compensation expense related to employees or directors stock options recognized during the three months and nine months ended September 30, 2005.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized

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in the consolidated statements of operations for the three months and nine months of 2006 consisted of compensation expense for the share-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). For stock-based payment awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with how the prior-period pro-formas were provided. As stock-based compensation expense recognized in the consolidated statements of operations for the three months and nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures which we estimate to be 7.7%. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro-forma information for the periods prior to fiscal 2006, we accounted for forfeitures as they occurred.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Our determination of fair value of share-based payment awards to employees and directors on the date of grant using the Black-Scholes model, which is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to our expected stock price volatility over the term of the awards. When valuing awards, we estimate its expected terms using the "safe harbor" provisions provided in SAB 107 and its volatility using historical data. We granted options to purchase 260,000 and 1,233,259 shares of common stock, respectively, during the three months and nine months of 2006. The options granted were fair valued in the aggregate at \$341,000 or \$1.31 per share during the third quarter of 2006. The options granted were fair valued in the aggregate at \$1.6 million or the weighted-average exercise price of \$1.86 during the nine months ended September 30, 2006. The stock-based compensation expense related to employees or director stock options recognized during the three months and nine months ended September 30, 2006 was \$90,000 and \$97,000, respectively.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

#### 3. STOCK-BASED COMPENSATION

Our Employee Incentive Plan, formerly the 1995 Stock Option Plan (the "1995 Plan"), authorized the grant of both incentive and non-qualified stock options to our officers, employees, directors and consultants for shares of our common stock. As of September 30, 2006, there were outstanding options to purchase a total of 1,319,000 shares of common stock granted under the 1995 Plan. No further grants may be made under the 1995 Plan. On May 25, 2006, we adopted 2006 Stock Incentive Plan (the "2006 Plan"), which authorizes the issuance of up to 5,100,000 shares of our common stock pursuant to options or awards granted under the 2006 Plan. As of September 30, 2006, there were outstanding options to purchase a total of 1,228,000 shares of common stock, and 3,872,000 shares remained available for issuance pursuant to award granted under the 2006 Plan. The exercise price of options under the plan must be equal to 100% of fair market value of common stock on the date of grant. The 2006 Plan also permits other types of awards, including stock appreciation rights,

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restricted stock and other performance-based benefits.

In October 1998, we granted 1,000,000 non-qualified stock options outside of the plan. The options were granted to our Chairman and Vice Chairman at \$13.50 per share, the closing sales price of the common stock on the day of the grant, expire in 2008 and vested over four years. In May 2002, we granted 3,000,000 non-qualified stock options outside of the plan. These options were granted to our Chairman, Vice Chairman and Mr. Kamel Nacif at \$5.50 per share, the closing sales price of the common stock on the day of the grant, expire in 2012 and vested over three years. The 1,000,000 stock options granted to Kamel Nacif were forfeited in 2005. In May 2003, we granted 2,000,000 non-qualified stock options outside of the plan to our Chairman and Vice Chairman. These options were granted at \$3.65 per share, the closing sales price of the common stock on the day of the grant, expire in 2013 and initially provided for vesting over four years. In December 2003, we granted 400,000 non-qualified stock options outside of the plan to one of our employees. The options were granted at \$3.94 per share, the closing sales price of the common stock on the day of the grant, expire in 2013 and initially provided for vesting over four years.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A summary of our stock option activity, and related information for the year ended December 31, 2005 and the nine months ended September 30, 2006 is as follows:

|   | EMPLOYEES           |                   |
|---|---------------------|-------------------|
|   | NUMBER OF<br>SHARES | EXERCISE<br>PRICE |
| Options outstanding at December 31, 2004 .....  | 8,331,962           | \$1.39-\$45.50    |
| Granted .....                                   | 42,000              | \$1.95-\$3.68     |
| Exercised .....                                 | --                  | --                |
| Forfeited .....                                 | (1,573,300)         | \$1.95-\$25.00    |
| Expired .....                                   | (67,612)            | \$ 4.50           |
| Options outstanding at December 31, 2005 .....  | 6,733,050           | \$1.39-\$45.50    |
| Granted .....                                   | 1,233,259           | \$1.84-\$1.94     |
| Exercised .....                                 | --                  | --                |
| Forfeited .....                                 | (19,450)            | \$1.94-\$33.13    |
| Expired .....                                   | --                  | --                |
| Options outstanding at September 30, 2006 ..... | 7,946,859           | \$1.39-\$45.50    |

We had no stock option outstanding to non-employees as of December 31, 2005 and September 30, 2006.

The following table summarizes information about stock options outstanding and exercisable as of December 31, 2005 and September 30, 2006:

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|                                  | NUMBER OF<br>SHARES | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | WEIGHTED<br>AVERAGE<br>REMAINING<br>CONTRACTUAL<br>LIFE<br>(YEARS) | INTRINSIC<br>VALUE |
|----------------------------------|---------------------|--|--|--------------------|
| As of December 31, 2005:         |                     |  |  |                    |
| Employees - Outstanding .....    | 6,733,050           | \$ 6.25                                  | 6.0  | \$ 12,440          |
| Employees - Expected to vest ... | 6,733,050           | \$ 6.25                                  | 6.0  | \$ 12,440          |
| Employees - Exercisable .....    | 6,733,050           | \$ 6.25                                  | 6.0  | \$ 12,440          |
| As of September 30, 2006:        |                     |  |  |                    |
| Employees - Outstanding .....    | 7,946,859           | \$ 5.56                                  | 6.0  | \$ 0               |
| Employees - Expected to vest ... | 7,852,283           | \$ 5.61                                  | 5.9  | \$ 0               |
| Employees - Exercisable .....    | 6,718,600           | \$ 6.24                                  | 5.3  | \$ 0               |

The total intrinsic value of options exercised during 2005 was \$0. Cash received from stock options exercised during 2005 was \$0. The total fair value of shares vested during the years ended December 31, 2003, 2004 and 2005, were approximately \$2.8 million, \$4.3 million, and \$5.7 million, respectively.

As of September 30, 2006, there was \$1.4 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over the weighted-average period of 3.7 years.

When options are exercised, our policy is to issue previously un-issued shares of common stock to satisfy share option exercises. As of September 30, 2006, we had 69.5 million shares of un-issued shares of common stock.

TARRANT APPAREL GROUP

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(Unaudited)

4. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

|  | SEPTEMBER 30,<br>2006 | DECEMBER 31,<br>2005 |
|--|-----------------------|----------------------|
| U.S. trade accounts receivable .....             | \$ 4,236,436          | \$ 2,893,217         |
| Foreign trade accounts receivable .....          | 12,943,876            | 19,619,172           |
| Factored accounts receivable .....               | 31,278,819            | 33,222,354           |
| Other receivables .....                          | 979,850               | 1,815,450            |
| Allowance for returns, discounts and bad debts . | (3,263,072)           | (2,951,750)          |
|  | =====                 | =====                |
|  | \$ 46,175,909         | \$ 54,598,443        |
|  | =====                 | =====                |

5. INVENTORY

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Inventory consists of the following:

|   | SEPTEMBER 30,<br>2006 | DECEMBER 31,<br>2005 |
|---|-----------------------|----------------------|
|   | -----                 | -----                |
| Raw materials - fabric and trim accessories ..... | \$ 3,896,436          | \$ 5,079,428         |
| Finished goods shipments-in-transit .....         | 7,648,321             | 8,800,014            |
| Finished goods .....                              | 8,910,945             | 17,749,518           |
|   | -----                 | -----                |
|   | \$ 20,455,702         | \$ 31,628,960        |
|   | =====                 | =====                |

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. The guaranteed annual minimum royalty is payable in equal monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. The guaranteed annual minimum royalty for 2006 is \$661,000. The minimum royalty paid and expensed for the three months and nine months ended September 30, 2006 was \$165,000 and \$496,000, respectively. At September 30, 2006, the total commitment on royalties remaining on the term was \$8.6 million. 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 approximately 100 select Macy's locations, and is currently available in approximately 600 Macy's stores nationally. In June 2006, we signed a guarantee of certain liabilities of American Rag CIE to California United Bank to the aggregate amount equal at all times to the lesser of (A) 45% of the aggregate amount of the outstanding liabilities and (B) \$675,000. Upon execution of the guarantee, we re-evaluated our investment under the provisions of FIN 46. In our analysis, we determined that consolidation under FIN 46 was still not appropriate. The investment in American Rag CIE, LLC totaling \$2.2 million at September 30, 2006, 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 months ended September 30, 2006 was as follows:

|                                       |              |
|---------------------------------------|--------------|
| Balance as of December 31, 2005 ..... | \$ 2,138,865 |
| Share of income.....                  | 103,015      |
| Distribution.....                     | (67,500)     |
|                                       | -----        |
| Balance as of September 30, 2006....  | \$ 2,174,380 |
|                                       | =====        |

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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7. NOTES RECEIVABLE - RELATED PARTY RESERVE

In connection with the sale in 2004 of our assets and real property in Mexico, the purchasers of the Mexico assets issued us unsecured promissory notes of \$3,910,000 that mature on November 30, 2007 and secured promissory notes of \$40,204,000 that mature on December 31, 2014 and are payable in partial or total amounts anytime prior to the maturity of each note. The secured notes are secured by the real and personal property in Mexico that we sold to the purchasers. As of September 30, 2006, the outstanding balance of the notes and interest receivables were \$41.1 million prior to the reserve. Historically, we have placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we have satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, the purchasers have recently ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in a amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately \$27.1 million, resulting in a net notes receivable balance at September 30, 2006 of approximately \$14 million. We will continue to pursue payment of all amounts under the notes receivable and believe the remaining \$14 million balance at September 30, 2006 is realizable. The entire reserve was recorded in the Luxembourg geographic reporting segment.

8. DEBT

Short-term bank borrowings consist of the following:

|                                       | SEPTEMBER 30,<br>2006 | DECEMBER 31,<br>2005 |
|---------------------------------------|-----------------------|----------------------|
|                                       | -----                 | -----                |
| Import trade bills payable - UPS, DBS |                       |                      |
| Bank and Aurora Capital .....         | \$ 4,651,308          | \$ 4,165,306         |
| Bank direct acceptances - UPS and DBS |                       |                      |
| Bank .....                            | 3,839,388             | 1,471,476            |
| Other Hong Kong credit facilities -   |                       |                      |
| UPS and DBS Bank .....                | 4,044,241             | 8,196,750            |
|                                       | -----                 | -----                |
|                                       | \$12,534,937          | \$13,833,532         |
|                                       | =====                 | =====                |

Long-term obligations consist of the following:

|   | SEPTEMBER 30,<br>2006 | DECEMBER 31,<br>2005 |
|---|-----------------------|----------------------|
|   | -----                 | -----                |
| Equipment financing .....               | 46,331                | 83,206               |
| Term loan - UPS .....                   | --                    | 2,708,333            |
| Debt facility - GMAC CF .....           | 19,749,079            | 33,558,095           |
| Credit facility - Guggenheim, net ..... | 10,941,948            | --                   |
|   | -----                 | -----                |
|   | 30,737,358            | 36,349,634           |
| Less current portion .....              | (19,769,030)          | (36,109,699)         |
|   | -----                 | -----                |

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|               |            |
|---------------|------------|
| \$ 10,968,328 | \$ 239,935 |
| =====         | =====      |

### 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 could arrange for the issuance of letters of credit and acceptances. The facility was collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by us and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman and Interim Chief Executive Officer, also signed a guarantee of \$5 million in favor of UPS to secure this facility. 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. Additionally, Gerard Guez, our Chairman and Interim Chief Executive Officer, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. On June 9, 2006, we completed the pay-off of all remaining amounts due under the letter of credit facility with UPS. As a result of the payment of these obligations, the letter of credit facility was terminated and all collateral released. There was no prepayment penalty under this arrangement. As of September 30, 2006, \$0 was outstanding under this facility with UPS.

Since March 2003, DBS Bank (Hong Kong) Limited ("DBS") had 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 was a demand facility and

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was secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, 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. In October 2005, a tax loan for HKD 6.233 million (equivalent to US \$804,000) was also made available to our Hong Kong subsidiaries and bears interest at the rate equal to the Hong Kong prime rate plus 1% and are subject to the same security. It bore interest at 9.25% per annum at September 30, 2006. As of September 30, 2006, \$70,000 was outstanding under this tax loan.

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS. Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries may borrow under this facility at any time is US \$25 million. The interest rate under the letter of credit facility is equal to the Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which the interest rate was 8.75% per annum at September 30, 2006, or the Standard Bills Rate quoted by DBS plus 0.5% if paid in any other currency, which the interest rate was 8.6% per annum at September 30, 2006. This is a demand facility and is secured by a security interest in all



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the assets of the Hong Kong subsidiaries, by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2006, interest coverage ratio, leverage ratio and limitations on additional indebtedness. As of September 30, 2006, \$12.3 million was outstanding under this facility. In addition, \$4.7 million of open letters of credit was outstanding and \$8.0 million was available for future borrowings as of September 30, 2006.

As of September 30, 2006, the total balance outstanding under the DBS credit facilities was \$12.4 million (classified above as follows: \$4.5 million in import trade bills payable, \$3.8 million in bank direct acceptances and \$4.1 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, 2006, \$164,000 was outstanding under this facility (classified above under import trade bills payable) and \$1.0 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 January 19, 2006, we borrowed \$4.0 million from Max Azria pursuant to the terms of a promissory note, which amount bore interest at the rate of 5.5% per annum and was payable in weekly installments of \$200,000 beginning on March 1, 2006. This was an unsecured loan. We paid off the remaining balance of this loan in July 2006. As of September 30, 2006, \$0 was outstanding under this loan.

### EQUIPMENT FINANCING

We had three equipment loans outstanding at December 31, 2005. One of these equipment loans bore interest at 6% payable in installments through 2009, which we paid off in January 2006. The second loan bears interest at 15.8% payable in installment through 2007 and the third loan bears interest at 6.15% payable in installment through 2007. In August 2006, we entered into a new auto loan that bears interest at 4.75% payable in installment through 2008. As of September 30, 2006, \$46,000 was outstanding under the three remaining loans.

### TERM LOAN - UPS

On December 31, 2004, our Hong Kong subsidiaries entered into a 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 was 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. Under the amended loan agreement, we were subject to restrictive financial covenants of maintaining tangible net worth of \$25 million at December 31, 2005

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and the last day of each fiscal quarter thereafter. There was also a provision capping maximum capital expenditure per quarter at \$800,000. The obligations under the loan agreement were collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan was 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 and Interim Chief Executive Officer, of 4.6 million shares of our common stock. On June 9, 2006, we completed the pay-off of all remaining amounts due under the term loan agreement with UPS. As a result of the payment of these obligations, the term loan agreement was terminated and all collateral released. There was no prepayment penalty under this arrangement.

### DEBT FACILITY AND FACTORING AGREEMENT - GMAC CF

On October 1, 2004, we amended and restated our previously existing credit facility with GMAC Commercial Finance Credit, LLC ("GMAC CF") by entering into a new factoring agreement with GMAC CF. 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 CF. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC CF, 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 CF, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC CF has the risk of loss and (b) \$40 million, minus in each case, any amount owed by us to GMAC CF. In May 2005, we amended our factoring agreement with GMAC CF to permit our subsidiaries party thereto and us, to borrow up to the lesser of \$3 million or 50% of the value of eligible inventory. In connection with this amendment, we granted GMAC CF a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC CF to increase the amount we may borrow against inventory to the lesser of \$5 million or 50% of the value of eligible inventory. The \$5 million limit was reduced to \$4 million on April 1, 2006.

On June 16, 2006, we expanded our credit facility with GMAC CF by entering into a new Loan and Security Agreement and amending and restating our previously existing Factoring Agreement with GMAC CF. UPS Capital Corporation is also a lender under the Loan and Security Agreement. This is a revolving credit facility and has a term of 3 years. The amount we may borrow under this credit facility is determined by a percentage of eligible accounts receivable and inventory, up to a maximum of \$55 million, and includes a letter of credit facility of up to \$4 million. Interest on outstanding amounts under this credit facility is payable monthly and accrues at the rate of the "prime rate" plus 0.5%. Our obligations under the GMAC CF credit facility are secured by a lien on substantially all our domestic assets, including a first priority lien on our accounts receivable and inventory. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness. This facility includes customary default provisions, and all outstanding obligations may become immediately due and payable in the event of a default. The facility bore interest at 8.75% per annum at September 30, 2006. As of September 30, 2006, we were in violation with the EBITDA covenant and a waiver was obtained during the default. A total of \$19.7 million was outstanding with respect to receivables factored under the GMAC CF facility at September 30, 2006.

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### CREDIT FACILITY FROM GUGGENHEIM CORPORATE FUNDING LLC AND WARRANTS

On June 16, 2006, we entered into a Credit Agreement with certain lenders and Guggenheim Corporate Funding LLC ("Guggenheim"), as administrative agent and collateral agent for the lenders. This credit facility provides for borrowings of up to \$65 million. This facility consists of an initial term loan of up to \$25 million, of which we borrowed \$15.5 million at the initial funding, to be used to repay certain existing indebtedness and fund general operating and working capital needs. An additional term loan of up to \$40 million will be available under this facility to finance acquisitions acceptable to Guggenheim. All amounts under the term loans become due and payable in December 2010. Interest under this facility is payable monthly, with the interest rate equal to the LIBOR rate plus an applicable margin based on our debt leverage ratio (as defined in the credit agreement). Our obligations under the Guggenheim credit facility are secured by a lien on substantially all of our assets and our domestic subsidiaries, including a pledge of the equity interests of our domestic subsidiaries and 65% of our Luxembourg subsidiary. This credit facility

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### TARRANT APPAREL GROUP

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contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness.

In connection with Guggenheim credit facility, on June 16, 2006, we issued the lenders under this facility warrants to purchase up to an aggregate of 3,857,143 shares of our common stock. These warrants have a term of 10 years. These warrants are exercisable at a price of \$1.88 per share with respect to 20% of the shares, \$2.00 per share with respect to 20% of the shares, \$3.00 per share with respect to 20% of the shares, \$3.75 per share with respect to 20% of the shares and \$4.50 per share with respect to 20% of the shares. The exercise prices are subject to adjustment for certain dilutive issuances pursuant to the terms of the warrants. 357,143 shares of the warrants will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at \$4.9 million using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. We also paid to Guggenheim 2.25% of the committed principal amount of the loans which was \$563,000 on June 16, 2006. The \$563,000 fee paid to Guggenheim is included in the deferred financing cost, and the value of the warrants to purchase 3.5 million shares of our common stock of \$4.9 million is recorded as debt discount, both of them are amortized over the life of the loan. As of September 30, 2006, \$352,000 was amortized.

Durham Capital Corporation acted as our advisor in connection with the Guggenheim credit facility. As compensation for its services, we agreed to pay Durham Capital a cash fee in an amount equal to 1% of the committed principal amount of the loans under the Guggenheim credit facility. As a result, \$250,000 was paid on June 16, 2006. In addition, we issued Durham Capital a warrant to

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purchase 77,143 shares of our common stock. This warrant has a term of 10 years and is exercisable at a price of \$1.88 per share, subject to adjustment for certain dilutive issuances. 7,143 shares of this warrant will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at \$105,000 using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. The \$250,000 fee paid to Durham Capital and the value of the warrants to purchase 70,000 shares of our common stock of \$105,000 is included in the deferred financing cost, and is amortized over the life of the loan. As of September 30, 2006, \$23,000 was amortized.

The Guggenheim facility bore interest at 12.33% per annum at September 30, 2006. As of September 30, 2006, we were in violation with the EBITDA covenant and a waiver was obtained during the default. A total of \$10.9 million, net of \$4.6 million of debt discount, was outstanding under this facility at September 30, 2006.

As of June 30, 2006, the warrants were being accounted for as a liability pursuant to the provisions of SFAS No. 133 and Emerging Issues Task Force ("EITF") No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19"). This is because we granted the warrant holders certain registration rights that are outside our control. In accordance with SFAS No. 133, the warrants are being valued at each reporting period. Changes in fair value are recorded as adjustment to fair value of derivative in the statements of operations. The outstanding warrants were fair valued on June 16, 2006, the date of the transaction, at \$5.0 million and we, in accordance with SFAS 133, revaluated the warrants on June 30, 2006 at the closing stock price on June 30, 2006 to \$5.2 million; as a result, an expense of \$218,000 was recorded as an adjustment to fair value of derivative on our consolidated statements of operations. On August 11, 2006, the registration rights agreement relating to the warrants was amended to provide that if we were unable to file or have the registration statement declared effective by the required deadlines, we would be required to pay the warrant holders cash payments as partial liquidated damages each month until the registration statement was filed and/or declared effective. The liquidated damages payable by us to the warrant holders are limited to 20% of the purchase price of the shares underlying the warrants, which we determined to be a reasonable discount for restricted stock as compared to registered stock. As a result of amending the registration rights relating to the warrants on August 11, 2006, the warrants were reclassified from debt to equity in accordance with EITF 00-19 in the third quarter of 2006. The outstanding warrants were revaluated on August 11, 2006 at the closing stock price on August 11, 2006 to

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\$4.5 million; as a result, income of \$729,000 was recorded as an adjustment to fair value of derivative on our consolidated statements of operations.

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The credit facilities with GMAC CF and Guggenheim include cross-default clauses subject to certain conditions. An event of default under the GMAC CF facility would constitute an event of default under the Guggenheim facility entitling Guggenheim to demand payment in full of all outstanding amounts under its facility. An event of default under the Guggenheim facility, under circumstances where Guggenheim has accelerated the debt or has exercised any other remedy available to Guggenheim which constitutes a Lien Enforcement Action under its Intercreditor Agreement with GMAC CF, would entitle GMAC CF to demand payment in full of all outstanding amounts under its debt facilities.

### 9. CONVERTIBLE DEBENTURES AND WARRANTS

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 Debentures were 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 was 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 financing cost paid to the placement agent of \$620,000, and the value of the warrants to purchase 200,000 shares of our common stock of \$138,000 were included in the deferred financing cost, net on our accompanying balance sheets and was 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 2006 was \$237,000. Total deferred financing cost amortized in the first nine months of 2006 was \$95,000. Total interest paid to the holders of the Debentures in the first nine months of 2006 was \$198,000. On June 26, 2006, we paid off the remaining balance of the outstanding Debentures of \$6.9 million plus all accrued

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and unpaid interest and a prepayment penalty of \$171,000. As a result of the repayment, the Debentures were terminated effective June 26, 2006. Upon paying off the Debentures, debt discount of \$278,000 related to the intrinsic value of the conversion option of \$804,000 was expensed, and of the \$620,000 financing cost paid to the placement agent, \$214,000 was expensed. The remaining value of the warrants to holders of our Debentures of \$433,000 and warrants to the placement agent of \$69,000 was also expensed.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

#### 10. 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. In connection with this settlement, in March 2006, we cancelled 10,000 shares of our common stock previously issued to him.

#### 11. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109," ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the effect that the application of FIN 48 will have on our results of operations and financial condition.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets" ("SFAS No. 156"), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to

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trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity's exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity's fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. We are currently evaluating the impact of this Statement.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are required to adopt the provision of SFAS No. 157, as applicable, beginning in fiscal year 2008. We do not believe the adoption of SFAS No. 157 will have a material impact on our financial position or results of operations.

### 12. 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.

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## TARRANT APPAREL GROUP

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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,

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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 \$7.7 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.

### 13. 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<br>SEPTEMBER 30, |              | NINE MONTHS ENDED<br>SEPTEMBER 30, |              |
|---|-------------------------------------|--------------|------------------------------------|--------------|
|   | 2006                                | 2005         | 2006                               | 2005         |
| Basic EPS Computation:  |                                     |              |                                    |              |
| Numerator .....   | \$(25,352,414)                      | \$ 1,702,417 | \$(23,904,758)                     | \$ 2,467,436 |
| Denominator:  |                                     |              |                                    |              |
| Weighted average common shares<br>outstanding .....           | 30,543,763                          | 30,365,502   | 30,546,217                         | 29,451,054   |
| Basic EPS .....   | \$ (0.83)                           | \$ 0.06      | \$ (0.78)                          | \$ 0.08      |
| Diluted EPS Computation:                                      |                                     |              |                                    |              |
| Numerator .....   | \$(25,352,414)                      | \$ 1,702,417 | \$(23,904,758)                     | \$ 2,467,436 |
| Denominator:  |                                     |              |                                    |              |
| Weighted average common shares<br>outstanding .....           | 30,543,763                          | 30,365,502   | 30,546,217                         | 29,451,054   |
| Incremental shares from assumed<br>exercise of warrants ..... | --                                  | 403,266      | --                                 | 59,040       |
| options .....   | --                                  | 17,029       | --                                 | 7,157        |
| Total shares .....  | 30,543,763                          | 30,785,797   | 30,546,217                         | 29,517,251   |
| Diluted EPS .....   | \$ (0.83)                           | \$ 0.06      | \$ (0.78)                          | \$ 0.08      |

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

Only 7,157 shares of outstanding options were included in the computation of net 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 outstanding options of 2006 were excluded from the computation of net loss per share in the nine months ended September 30, 2006 as the impact would be anti-dilutive. All warrants were excluded from the computation of net income (loss) per share in the nine months ended September 30, 2006 and 2005, as the impact would be anti-dilutive. The effect of applying "IF Converted Method" to the convertible



## TARRANT APPAREL GROUP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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debenture was anti-dilutive; therefore, it was excluded from the computation of income per share in the nine months ended September 30, 2006 and 2005. The following table presents outstanding options, warrants and convertible debentures.

|                        | AS OF SEPTEMBER 30, |            |
|------------------------|---------------------|------------|
|                        | 2006                | 2005       |
|                        | -----               | -----      |
| Options .....          | 7,946,859           | 6,745,175  |
| Warrants .....         | 5,931,732           | 2,361,732  |
| Convertible debentures | --                  | 3,456,313  |
|                        | -----               | -----      |
| Total .....            | 13,878,591          | 12,563,220 |
|                        | =====               | =====      |

## 14. RELATED PARTY TRANSACTIONS

As of September 30, 2006, related party affiliates were indebted to us in the amounts of \$8.3 million. These include amounts due from Gerard Guez, our Chairman and Interim Chief Executive Officer. 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 2006 was approximately \$2,234,000. At September 30, 2006, the entire balance due from Mr. Guez totaling \$2.2 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All advances to Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$129,000 and \$165,000 for the nine months ended September 30, 2006 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately \$226,000 and \$321,000 for the nine months ended September 30, 2006 and 2005, 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 and Interim Chief Executive Officer, called United Apparel Ventures, LLC. 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

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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.

At September 30, 2006, Messrs. Guez and Kay beneficially owned 590,000 and 1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc., collectively representing approximately 8.7% of Tag-It Pacific's common stock. Tag-It Pacific is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Starting from 1998, Tag-It Pacific 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 Pacific no longer manages our trim and packaging requirements. We purchased \$205,000 and \$55,000 of trim inventory from Tag-It Pacific in the nine months ended September 30, 2006 and 2005, respectively. Our sales of garment accessories to Tag-It Pacific were \$39,000 and \$0 in the nine months ended September 30, 2006 and 2005, respectively. We purchased \$0 and \$135,000 of finished goods and services from Azteca and its affiliates in the nine months ended September 30, 2006 and 2005, respectively. Our sales of fabric and services to Azteca in the nine months ended September 30, 2006 and 2005 was \$9,000 and \$63,000, respectively.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing Company, LLC ("Seven Licensing") to be its buying agent to source and purchase apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Net amount due from these related parties as of September 30, 2006 was \$5.5 million.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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, 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 \$41.0 million notes receivable - related party on the accompanying balance sheet as of September 30, 2006 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Historically, we have placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we have satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, the purchasers have recently ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the

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underlying assets securing the notes. The loss was estimated to be approximately \$27.1 million, resulting in a notes receivable balance at September 30, 2006 of approximately \$14 million. We will continue to pursue payments under the notes receivable and believe the remaining \$14 million balance at September 30, 2006 is realizable. 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 \$0 and \$4.1 million of fabric from Acabados y Terminados in the nine months ended September 30, 2006 and 2005, respectively. In addition to the above notes receivable, net amount due from these parties as of September 30, 2006 was \$412,000, related to reimbursement expenses.

We lease our executive offices in Los Angeles, California from GET, a corporation which is owned by Gerard Guez (our Chairman and Interim Chief Executive Officer) and Todd Kay (our Vice Chairman). Additionally, we lease our warehouse and office space in Hong Kong from Lynx International Limited, a Hong Kong corporation that is owned by Messrs. Guez and Kay. We paid \$807,000 and \$764,000 in rent in the nine months ended September 30, 2006 and 2005, respectively, for office and warehouse facilities. During the first seven months of 2006, our Los Angeles offices and warehouse was leased on a month to month basis. On August 1, 2006, we entered into a lease agreement with GET for the Los Angeles offices and warehouse, which lease has a term of five years with an option to renew for an additional five year term. On January 1, 2006, we renewed our lease agreement with Lynx International Limited for our office space in Hong Kong for one year.

On May 1, 2006, we sublet our executive office in Los Angeles, California and our sales office in New York to Seven Licensing Company, LLC ("Seven Licensing") for a monthly payment of \$25,000 on a month to month basis. Seven Licensing is beneficially owned by Gerard Guez, our Chairman and Interim Chief Executive Officer. We received \$125,000 in rental income from this sublease in the nine months ended September 30, 2006.

At September 30, 2006, we had various employee receivables totaling \$258,000 included in due from related parties.

We believe that 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.

### 15. COMMITMENTS AND CONTINGENCIES

On January 3, 2005, Private Brands, Inc., our wholly owned subsidiary, entered into a term sheet exclusive licensing agreement with Beyond Productions, LLC and Kids Headquarters to collaborate on the design, manufacturing and distribution of women's contemporary, large sizes and junior apparel bearing the brand name "House of Dereon", Couture, Kick and Soul. This agreement was a three-year contract, and providing compliance with all terms of the license, was renewable for one additional three-year term. The agreement also provided payment of royalties at the rate of 8% on net sales and 3% on net sales for marketing fund commitments. In the first quarter of 2005, we advanced \$1.2 million as payment for the first year's minimum royalty and marketing fund commitment. We had applied \$34,000 from the above advance against the royalty

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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and marketing expenses in 2005. In March 2006, we agreed to terminate our agreement to design, market and sell House of Dereon by Tina Knowles branded apparel and we agreed to sell all remaining inventory to the licensor or its designee. As a result, we will no longer be involved in the sales of this private brand. Prior to December 31, 2005, we had written off the capitalized balance of \$1.2 million related to the first year term of the agreement and recognized a corresponding loss in 2005.

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. 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. In December 2004, we advanced \$2.2 million as payment for the first year's minimum royalties. We applied \$1.1 million from the above advance against the royalty and marketing expenses in 2005 and \$884,000 in the first three months of 2006. In March 2006, we had written off the capitalized balance of \$192,000 and recognized a corresponding loss. The loss was classified as royalty expense on our consolidated statements of operations. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands. We are presently in litigation with the licensor. See Note 17 of the "Notes to Consolidated Financial Statements"

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. The guaranteed annual minimum royalty is payable in equal monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. At September 30, 2006, the total commitment on royalties remaining on the term was \$8.6 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 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 \$0 and \$3.2 million of fabric under this agreement in the nine months ended September 30, 2006 and 2005, respectively.

In July 2006, we terminated our License Agreements and the parent guaranty with Cynthia Rowley. In consideration of termination of the License Agreements, \$400,000 was paid to Cynthia Rowley in July 2006.

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On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing Company, LLC ("Seven Licensing") to be its buying agent to source and purchase apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Net amount due from these related parties as of September 30, 2006 was \$5.5 million.

On August 1, 2006, we entered into a lease agreement with GET for the Los Angeles offices and warehouse, which lease has a term of five years with an option to renew for an additional five year term. On January 1, 2006, we renewed our lease agreement with Lynx International Limited for our office space in Hong Kong for one year.

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### TARRANT APPAREL GROUP

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

#### 16. 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 four geographic regions: the United States, Asia, Mexico and Luxembourg. 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, Mexico and Luxembourg is presented below. Inter-company revenues and assets have been eliminated to arrive at the consolidated amounts.

|   | UNITED STATES<br>----- | ASIA<br>----- | MEXICO<br>----- | LUXEMBOURG<br>----- | ADJUSTM<br>AND<br>ELIMINAT |
|---|------------------------|---------------|-----------------|---------------------|----------------------------|
| THREE MONTHS ENDED                                |                        |               |                 |                     |                            |
| SEPTEMBER 30, 2006                                |                        |               |                 |                     |                            |
| Sales .....                                       | \$ 53,092,000          | \$ 1,545,000  | \$ 8,000        | \$ --               | \$                         |
| Inter-company sales .....                         | --                     | 28,221,000    | --              | --                  | (28,221,000)               |
|   | -----                  | -----         | -----           | -----               | -----                      |
| Total revenue .....                               | \$ 53,092,000          | \$ 29,766,000 | \$ 8,000        | \$ --               | \$ (28,221,000)            |
|   | =====                  | =====         | =====           | =====               | =====                      |
| Income (loss) from operations .....               | \$ 1,510,000           | \$ 1,057,000  | \$ (144,000)    | \$ (27,142,000)     | \$                         |
|   | =====                  | =====         | =====           | =====               | =====                      |
| Interest income .....                             | \$ 137,000             | \$ 796,000    | \$ --           | \$ 28,000           | \$ (796,000)               |
|   | =====                  | =====         | =====           | =====               | =====                      |
| Interest expense .....                            | \$ 1,530,000           | \$ 32,000     | \$ 1,000        | \$ 795,000          | \$ (796,000)               |
|   | =====                  | =====         | =====           | =====               | =====                      |
| Provision for depreciation and amortization ..... | \$ 574,000             | \$ 28,000     | \$ --           | \$ --               | \$                         |
|   | =====                  | =====         | =====           | =====               | =====                      |
| Capital expenditures .....                        | \$ 31,000              | \$ 36,000     | \$ --           | \$ --               | \$                         |

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|  | =====         | =====         | =====      | =====       | =====           |
|--|---------------|---------------|------------|-------------|-----------------|
| THREE MONTHS ENDED<br>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<br>operations .....               | \$ 309,000    | \$ 2,568,000  | \$ 168,000 | \$ (34,000) | \$              |
| Interest income .....                                | \$ 46,000     | \$ 525,000    | \$ --      | \$ 459,000  | \$ (524,000)    |
| Interest expense .....                               | \$ 1,206,000  | \$ 95,000     | \$ --      | \$ 524,000  | \$ (524,000)    |
| Provision for depreciation<br>and amortization ..... | \$ 462,000    | \$ 26,000     | \$ --      | \$ --       | \$              |
| Capital expenditures .....                           | \$ 186,000    | \$ 75,000     | \$ 112,000 | \$ --       | \$              |

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TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

|  | UNITED STATES  | ASIA          | MEXICO       | LUXEMBOURG      | AD<br>EL |
|--|----------------|---------------|--------------|-----------------|----------|
|  | -----          | -----         | -----        | -----           | -----    |
| NINE MONTHS ENDED<br>SEPTEMBER 30, 2006              |                |               |              |                 |          |
| Sales .....  | \$ 172,538,000 | \$ 2,526,000  | \$ (75,000)  | \$ --           | \$       |
| Inter-company sales .....                            | --             | 89,145,000    | --           | --              | (        |
| Total revenue .....                                  | \$ 172,538,000 | \$ 91,671,000 | \$ (75,000)  | \$ --           | \$ (     |
| Income (loss) from<br>operations .....               | \$ 3,859,000   | \$ 3,367,000  | \$ (547,000) | \$ (27,144,000) | \$       |
| Interest income .....                                | \$ 229,000     | \$ 2,190,000  | \$ --        | \$ 901,000      | \$       |
| Interest expense .....                               | \$ 4,525,000   | \$ 159,000    | \$ 12,000    | \$ 2,188,000    | \$       |
| Provision for depreciation<br>and amortization ..... | \$ 2,302,000   | \$ 82,000     | \$ --        | \$ --           | \$       |

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|  |                |                |               |                |       |
|--|----------------|----------------|---------------|----------------|-------|
| Capital expenditures .....                           | \$ 63,000      | \$ 67,000      | \$ --         | \$ --          | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Total assets .....                                   | \$ 114,484,000 | \$ 117,481,000 | \$ 14,528,000 | \$ 183,588,000 | \$ (3 |
|  | =====          | =====          | =====         | =====          | ===== |
| NINE MONTHS ENDED                                    |                |                |               |                |       |
| SEPTEMBER 30, 2005                                   |                |                |               |                |       |
| Sales .....  | \$ 163,828,000 | \$ 1,006,000   | \$ 100,000    | \$ --          | \$    |
| Inter-company sales .....                            | --             | 105,576,000    | --            | --             | (1    |
|  | -----          | -----          | -----         | -----          | ----- |
| Total revenue .....                                  | \$ 163,828,000 | \$ 106,582,000 | \$ 100,000    | \$ --          | \$ (1 |
|  | =====          | =====          | =====         | =====          | ===== |
| Income (loss) from<br>operations .....               | \$ (537,000)   | \$ 5,444,000   | \$ (192,000)  | \$ (34,000)    | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Interest income .....                                | \$ 169,000     | \$ 1,345,000   | \$ --         | \$ 1,406,000   | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Interest expense .....                               | \$ 3,090,000   | \$ 309,000     | \$ 1,000      | \$ 1,344,000   | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Provision for depreciation<br>and amortization ..... | \$ 1,664,000   | \$ 75,000      | \$ --         | \$ --          | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Capital expenditures .....                           | \$ 278,000     | \$ 175,000     | \$ --         | \$ --          | \$    |
|  | =====          | =====          | =====         | =====          | ===== |
| Total assets .....                                   | \$ 141,941,000 | \$ 128,811,000 | \$ 32,006,000 | \$ 212,387,000 | \$ (3 |
|  | =====          | =====          | =====         | =====          | ===== |

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TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

17. LITIGATION

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands (captioned Tarrant Apparel Group v. Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson) in the Supreme Court of the State of New York, County of New York. The suit named Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson as defendants, and asserts that the defendants failed to provide promised support in connection with our sublicense agreement for the Jessica Simpson brands. Our complaint includes eight causes of action, including two seeking a declaration that the sublicense agreement is exclusive and remains in full force and effect, as well as claims for breach of contract by Camuto Consulting, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto Consulting, and a claim against With You, Inc. and Ms. Simpson that we are an intended third party beneficiary of the licenses between those defendants and Camuto Consulting. On or about April 26, 2006, Camuto Consulting served its answer to our complaint and included a counterclaim against us for breach of the sublicense agreement and alleging damages of no less than \$100 million. Camuto

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Consulting has also served a motion to dismiss our cause of action for fraudulent inducement. On or about May 22, 2006, we served our reply to Camuto Consulting's counterclaim. On or about April 27, 2006, Ms. Simpson served a motion seeking dismissal of the cause of action asserted against her. On or about May 10, 2006, we served our opposition to Ms. Simpson motion to dismiss. On or about June 14, 2006, we served a cross-motion seeking leave to amend our complaint to add Vincent Camuto as a defendant. On October 18, 2006, the Court: (i) granted our cross-motion seeking leave to file a supplemental summons and amended complaint adding Vincent Camuto as a defendant and supplementing the allegations of fraud against Camuto Consulting; (ii) denied Camuto Consulting's motion to dismiss the cause of action for fraudulent inducement; and (iii) denied Ms. Simpson's motion to dismiss the cause of action asserted against her. On or about October 30, 2006, Camuto Consulting and Vincent Camuto served their answer to the amended complaint, with a counterclaim that is virtually identical to the original counterclaim. We intend to continue to vigorously defend Camuto's counterclaim and vigorously oppose Ms. Simpson's motion. Discovery in the matter has been underway since May 2006. A status conference is scheduled before the Court on November 21, 2006.

Shortly before May 2004, Bazak International Corp. commenced an action against us in the New York County Supreme Court claiming that we breached an oral contract to sell a quantity of close-out goods, as a consequence of which Bazak was damaged to the extent of \$1.3 million. Bazak International Corp. claimed that our liability exists under a theory of breach of contract or unjust enrichment. This case is currently pending in the United States District Court for the Southern District of New York and is scheduled for trial on November 27, 2006. We will continue to vigorously defend against the breach of contract and unjust enrichment claim.

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.

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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 Kohl's, Chico's, Macy's Merchandising Group, Mervyn's, Mothers Work, Sears, Wal-Mart, Dillard's, Lane Bryant, Lerner New York, and the Avenue. 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 and Alain Weiz.

#### PRIVATE LABEL

Private label business has been our core competency for over twenty years, and involves a one to one relationship with a large, centrally controlled retailer with whom we can develop product lines that fit with the characteristics of their particular customer. Private label net sales in the



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first nine months of 2006 were \$135.8 million compared to \$119.5 million in the first nine months of 2005.

The exposure of developing 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 2005, and are on track to be significant growth areas for 2006.

### PRIVATE BRANDS

We launched our private brands initiative in 2003, pursuant to which we acquire ownership of or license rights to a brand name and sell apparel products under this brand, generally to a single retail company within a geographic region. Private brands net sales in the first nine months of 2006 were \$39.2 million compared to \$45.4 million in the first nine months of 2005. During the nine months ended September 30, 2006, we owned or licensed rights to the following private brands:

- o AMERICAN RAG CIE: During the first quarter of 2005, we extended our agreement with Macy's Merchandising Group for nine 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 600 stores. Net sales of American Rag Cie branded apparel totaled \$23.1 million in the first nine months of 2006.
- o ALAIN WEIZ: We continue to sell Alan Weiz apparel exclusively to Dillard's Department Stores. Net sales of Alain Weiz branded apparel totaled \$4.6 million in the first nine months of 2006.
- o SOUVENIR BY CYNTHIA ROWLEY: In July 2006, we terminated our License Agreements and the parent guaranty with Cynthia Rowley. In consideration of termination of the License Agreements, \$400,000 was paid to Cynthia Rowley in July 2006.
- o GEAR 7: During the fourth quarter of 2005, K-Mart discontinued sales of Gear 7 products, which resulted in a decline in sales for this brand in the fourth quarter of 2005. We do not anticipate sales of Gear 7 branded apparel in 2006.
- o JESSICA SIMPSON brands: The JS by Jessica Simpson brand was originally launched as a denim line with Charming Shoppes. Net sales of JS by Jessica Simpson and Princy by Jessica Simpson, which is the department store and better specialty store brand, totaled \$9.3 million in the first quarter of 2006. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands, and we are presently in litigation with this licensor. Accordingly, we did not have any sales of Jessica Simpson branded apparel after the first quarter of 2006 and do not anticipate any sales unless and until we are able to successfully resolve our dispute and retain our rights to these brands.

- o HOUSE OF DEREON BY TINA KNOWLES: We began shipping products

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for the House of Dereon by Tina Knowles brand in the fourth quarter of 2005, resulting in net sales of \$309,000 in 2005. In March 2006, we terminated our license agreement for this brand, and sold our remaining inventory to the licensor or its designee. Prior to December 31, 2005, we had written off the capitalized balance of \$1.2 million related to the agreement and recognized a corresponding loss in 2005. Net sales of House of Dereon by Tina Knowles branded apparel totaled \$2.2 million in the first quarter of 2006 which included \$1.5 million of sales of inventory to a designee of the licensor.

### NOTES RECEIVABLE - RELATED PARTY RESERVE

In connection with the sale in 2004 of our assets and real property in Mexico, the purchasers of the Mexico assets issued us unsecured promissory notes of \$3,910,000 that mature on November 30, 2007 and secured promissory notes of \$40,204,000 that mature on December 31, 2014 and are payable in partial or total amounts anytime prior to the maturity of each note. The secured notes are secured by the real and personal property in Mexico that we sold to the purchasers. As of September 30, 2006, the outstanding balance of the notes and interest receivables were \$41.1 million prior to the reserve. Historically, we have placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we have satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, the purchasers have recently ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in a amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately \$27.1 million, resulting in a net notes receivable balance at September 30, 2006 of approximately \$14 million. We will continue to pursue payment of all amounts under the notes receivable and believe the remaining \$14 million balance at September 30, 2006 is realizable. The entire reserve was recorded in the Luxembourg geographic reporting segment.

### CREDIT FACILITY REFINANCING

In June 2006, we entered into a new \$65 million credit facility with Guggenheim Corporate Funding, LLC (as agent for certain lenders) and expanded our existing facilities with GMAC Commercial Finance Credit, LLC and DBS Bank (Hong Kong) Limited. The credit facility with Guggenheim consists of an initial term loan of \$25 million, of which \$15.5 million was advanced at the initial closing. The initial term loan was or will be used to repay certain existing indebtedness and fund general operating and working capital needs. A second term loan of up to \$40 million will be available to finance acquisitions acceptable to Guggenheim as agent. In addition, in June 2006, our credit facility with GMAC Commercial Finance Credit, LLC and other lenders was increased from \$45 million to \$55 million, and our credit facility with DBS Bank (Hong Kong) Limited was increased from \$4.5 million to \$25 million. These financings significant expand our borrowing base, which provides enhanced financial flexibility to us.

### 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

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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 \$7.7 million. We do not believe that the adjustments, if any, arising

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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 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, notes receivable - related parties reserve, intangible assets, income taxes, stock options valuation, 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.

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, 2005.

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

We evaluate the collectibility of accounts receivable and chargebacks

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(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 to us could be reduced by a material amount.

As of September 30, 2006, the balance in the allowance for returns, discounts and bad debts reserves was \$3.3 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:

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- 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 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, 2006, we have a goodwill balance of \$8.6 million, and a net property and equipment balance of \$1.5 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

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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 12 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 EBITDA and tangible net worth as discussed in Note 8 of the "Notes to Consolidated Financial Statements." As of September 30, 2006, we were in violation with the EBITDA covenants and waivers were obtained during the default. 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.

### VALUATION OF DERIVATIVE INSTRUMENTS

Statements of Financial Accounting Standards ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities" requires measurement of certain derivative instruments at their fair value for accounting purposes. In determining the appropriate fair value, we use the Black-Scholes-Merton Option Pricing Formula (the

"Black-Scholes Model"). Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in consolidated statements of operations as adjustments to fair value of derivatives.

### NEW ACCOUNTING PRONOUNCEMENTS

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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 11 of the "Notes to Consolidated Financial Statements."

### 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<br>SEPTEMBER 30, |        | NINE MONTHS ENDED<br>SEPTEMBER 30, |        |
|---|-------------------------------------|--------|------------------------------------|--------|
|   | 2006                                | 2005   | 2006                               | 2005   |
| Net sales .....   | 100.0%                              | 100.0% | 100.0%                             | 100.0% |
| Cost of sales .....                                       | 78.4                                | 79.1   | 78.9                               | 78.8   |
| Gross profit .....  | 21.6                                | 20.9   | 21.1                               | 21.2   |
| Selling and distribution expenses .                       | 4.7                                 | 4.1    | 4.7                                | 4.7    |
| General and administration expenses                       | 12.0                                | 10.6   | 11.4                               | 12.3   |
| Royalty expenses .....                                    | 0.5                                 | 1.9    | 1.2                                | 1.3    |
| Loss on notes receivable - related parties .....          | 49.7                                | --     | 15.5                               | --     |
| Income (loss) from operations .....                       | (45.3)                              | 4.3    | (11.7)                             | 2.9    |
| Interest expense .....                                    | (2.8)                               | (1.9)  | (2.7)                              | (2.1)  |
| Interest Income .....                                     | 0.3                                 | 0.7    | 0.7                                | 1.0    |
| Interest in income (loss) of equity method investee ..... | 0.0                                 | 0.2    | 0.1                                | 0.3    |
| Other income .....  | 0.2                                 | 0.1    | 0.1                                | 0.1    |
| Adjustment to fair value of derivative .....              | 1.3                                 | (0.0)  | 0.3                                | (0.0)  |
| Other expense .....                                       | 0.0                                 | (0.0)  | (0.2)                              | (0.0)  |
| Minority interest in consolidated subsidiary .....        | 0.0                                 | (0.2)  | 0.0                                | (0.1)  |
| Income (loss) before taxes .....                          | (46.3)                              | 3.2    | (13.4)                             | 2.1    |
| Income taxes .....  | 0.1                                 | 0.7    | 0.2                                | 0.6    |
| Net income (loss) .....                                   | (46.4)%                             | 2.5%   | (13.6)%                            | 1.5%   |

### THIRD QUARTER 2006 COMPARED TO THIRD QUARTER 2005

Net sales decreased by \$14.9 million, or 21.4%, to \$54.6 million in the third quarter of 2006 from \$69.6 million in the third quarter of 2005. Sales of private label in the third quarter of 2006 were \$46.1 million compared to \$47.0 million in the same period of 2005, with the decrease resulting primarily from decreased sales to Wal-Mart, offset by increased sales to Charlotte Russe, Mothers Work and Mervyn's. Sales of private brands in the third quarter of 2006 were \$8.5 million compared to \$22.6 million in the same period of 2005 with the decrease resulting primarily from no sales of Gear7 and Jessica Simpson brands in the third quarter of 2006.

Gross profit consists of net sales less product costs, direct labor, manufacturing overhead, duty, quota, freight in, brokerage, and warehousing.

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Gross profit decreased by \$2.7 million to \$11.8 million in the third quarter of 2006 from \$14.5 million in the third quarter of 2005. The decrease in gross profit occurred primarily because of a decrease in sales. As a percentage of net sales, gross profit increased from 20.9% in the third quarter of 2005 to 21.6% in the third quarter of 2006. The increase in gross margin is primarily attributable to changes in customer mix in private label and improved sourcing in private brand business in the third quarter of 2006 as compared to the same period of 2005.

Selling and distribution expenses decreased by \$278,000, or 9.8%, to \$2.6 million in the third quarter of 2006 from \$2.8 million in the third quarter of 2005. As a percentage of net sales, these expenses increased to 4.7% in the third quarter of 2006 from 4.1% in the third quarter of 2005 due to decreased sales during the third quarter of 2006.

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General and administrative expenses decreased by \$847,000, or 11.5%, to \$6.6 million in the third quarter of 2006 from \$7.4 million in the third quarter of 2005. The decrease was primarily due to reduced overhead associated with our private brands business. As a percentage of net sales, these expenses increased to 12.0% in the third quarter of 2006 from 10.6% in the third quarter of 2005 due to decreased sales during the third quarter of 2006.

Royalty and marketing allowance expenses decreased by \$1.0 million, or 79.5%, to \$264,000 in the third quarter of 2006 from \$1.3 million in the third quarter of 2005. As a percentage of net sales, these expenses decreased to 0.5% in the third quarter of 2006 from 1.9% in the third quarter of 2005.

Loss on notes receivable - related parties was \$27.1 million, or 49.7% of net sales, in the third quarter of 2006, compared to \$0 in the third quarter of 2005. The purchasers of the Mexico assets have recently ceased providing fabric and are not currently making payments under the notes. We evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. See Note 7 of the "Notes to Consolidated Financial Statements".

Operating loss in the third quarter of 2006 was \$24.7 million, or (45.3)% of net sales, compared to operating income of \$3.0 million, or 4.3% of net sales, in the comparable period of 2005, primarily due to loss on notes receivable - related parties in the amount of \$27.1 million and the other factors discussed above.

Interest expense increased by \$261,000, or 20.1%, to \$1.6 million in the third quarter of 2006 from \$1.3 million in the third quarter of 2005. As a percentage of net sales, this expense increased to 2.8% in the third quarter of 2006 from 1.9% in the third quarter of 2005. Interest income decreased by \$341,000, or 67.3%, to \$165,000 in the third quarter of 2006 from \$506,000 in the third quarter of 2005. Other income was \$109,000 in the third quarter of 2006, compared to \$39,000 in the third quarter of 2005. Adjustment to fair value of derivative was \$729,000 in the third quarter of 2006, compared to \$0 in the third quarter of 2005. Other expense was \$0 in the third quarter of 2006 and 2005.

Losses allocated to minority interests in the third quarter of 2006 were \$14,000, representing the minority partner's share of losses in PBG7. Income allocated to minority interests in the third quarter of 2005 were \$164,000, representing the minority partner's share of profit in PBG7.

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### FIRST NINE MONTHS OF 2006 COMPARED TO FIRST NINE MONTHS OF 2005

Net sales increased by \$10.1 million, or 6.1%, to \$175.0 million in the first nine months of 2006 from \$164.9 million in the first nine months of 2005. Sales of private label in the first nine months of 2006 were \$135.8 million compared to \$119.5 million in the same period of 2005, with the increase resulting primarily from increased sales to Kohl's, Charlotte Russe, Chico's, Mervyn's and Mothers Work and offset by decreased sales to Wal-Mart and Lerner. Sales of private brands in the nine months of 2006 were \$39.2 million compared to \$45.4 million in the same period of 2005.

Gross profit increased by \$2.0 million to \$37.0 million in the first nine months of 2006 from \$34.9 million in the first nine months of 2005. The increase in gross profit occurred primarily because of an increase in sales. As a percentage of net sales, gross profit decreased slightly from 21.2% in the first nine months of 2005 to 21.1% in the first nine months of 2006.

Selling and distribution expenses increased by \$483,000, or 6.2%, to \$8.3 million in the first nine months of 2006 from \$7.8 million in the first nine months of 2005, due primarily to increased sales. As a percentage of net sales, these expenses remained unchanged at 4.7% for the first nine months of 2005 and 2006.

General and administrative expenses decreased by \$356,000, or 1.8%, to \$19.9 million in the first nine months of 2006 from \$20.3 million in the first nine months of 2005. As a percentage of net sales, these expenses decreased to 11.4% in the first nine months of 2006 from 12.3% in the first nine months of 2005 due to increased sales during the first nine months 2006. Included in the general and administrative expenses in the first nine months of 2006 was \$284,000 of expensing the financing cost paid to the placement agent and the remaining value of the

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warrants to placement agent and \$171,000 of prepayment penalty paid to the debenture holders as a result of the repayment of the Debentures.

Royalty and marketing allowance expenses decreased by \$82,000, or 3.8%, to \$2.1 million in the first nine months of 2006 from \$2.2 million in the first nine months of 2005. As a percentage of net sales, these expenses decreased to 1.2% in the first nine months of 2006 from 1.3% in the first nine months of 2005.

Loss on notes receivable - related parties was \$27.1 million, or 15.5% of net sales, in the first nine months of 2006, compared to \$0 in the first nine months of 2005. The purchasers of the Mexico assets have recently ceased providing fabric and are not currently making payments under the notes. We evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. See Note 7 of the "Notes to Consolidated Financial Statements".

Operating loss for the first nine months of 2006 was \$20.5 million, or (11.7)% of net sales, compared to operating income of \$4.7 million, or 2.9% of net sales, in the comparable prior period of 2005 as a result of the loss on notes receivable - related parties in the amount of \$27.1 million and the other factors discussed above.



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Interest expense increased by \$1.3 million or 38.1%, to \$4.7 million in the first nine months of 2006 from \$3.4 million in the first nine months of 2005. As a percentage of net sales, this expense increased to 2.7% in the first nine months of 2006 from 2.1% in the first nine months of 2005. The increase was primarily due to expensing \$711,000 in the first nine months of 2006 of debt discount related to the intrinsic value of the conversion option of Debentures and the remaining value of the warrants to holders of Debentures as a result of the repayment of the Debentures in June 2006. Interest income decreased by \$444,000 or 28.2%, to \$1.1 million in the first nine months of 2006 from \$1.6 million in the first nine months of 2005. Other income was \$233,000 in the first nine months of 2006, compared to \$278,000 in the first nine months of 2005. Adjustment to fair value of derivative was \$511,000 in the first nine months of 2006, compared to \$0 in the first nine months of 2005. Other expense was \$400,000 in the first nine months of 2006, compared to \$0 in the first nine months of 2005.

Losses allocated to minority interests in the first nine months of 2006 were \$18,000, representing the minority partner's share of losses in PBG7. Income allocated to minority interests in the first nine months of 2005 were \$164,000, representing the minority partner's share of profit in PBG7.

### 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 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
- o changes in our working capital requirements.

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

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- 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, 2006 and 2005 were as follows (dollars in thousands):

| CASH FLOWS:                    | 2006       | 2005        |
|--------------------------------|------------|-------------|
|                                | -----      | -----       |
| Net cash provided by (used in) |            |             |
| operating activities .....     | \$ 10,297  | \$ (22,802) |
| Net cash provided by investing |            |             |
| activities .....               | \$ 1,125   | \$ 3,316    |
| Net cash (used in) provided by |            |             |
| financing activities .....     | \$(12,087) | \$ 19,908   |

During the first nine months of 2006, net cash provided by operating activities was \$10.3 million, as compared to net cash used in operating activities of \$22.8 million for the same period in 2005. Net cash provided by operating activities in the first nine months of 2006 resulted primarily from a net loss of \$23.9 million and the decrease of \$15.1 million in accounts payable, offset by \$27.1 million of loss on notes receivable - related parties, \$2.4 million of depreciation and amortization expense, a decrease of \$7.3 million in accounts receivable, and a decrease in inventory of \$11.2 million. The decrease in inventory was primarily due to the increase in sales in the first nine months of 2006, and the decrease in accounts payable resulted from the pay down of payables.

During the first nine months of 2006, net cash provided by investing activities was \$1.1 million, as compared to net cash provided by investing activities of \$3.3 million for the same period in 2005. Net cash provided by investing activities in the first nine months of 2006 resulted primarily from the collection on notes receivable.

During the first nine months of 2006, net cash used in financing activities was \$12.1 million, as compared to net cash provided by financing activities of \$19.9 million for the same period in 2005. Net cash used in financing activities in the first nine months of 2006 resulted primarily from \$1.3 million net repayments of our short-term bank borrowings, net repayments of our long-term obligations of \$16.5 million, and repayments of borrowings from convertible debentures of \$6.9 million, offset by financing of \$15.5 million under our credit facility with Guggenheim.

### CONTRACTUAL OBLIGATIONS AND COMMITMENTS

Following is a summary of our contractual obligations and commercial commitments available to us as of September 30, 2006 (in millions):

| CONTRACTUAL OBLIGATIONS  | PAYMENTS DUE BY PERIOD |                        |                         |                         |                  |
|--------------------------|------------------------|------------------------|-------------------------|-------------------------|------------------|
|                          | Total                  | Less<br>than<br>1 year | Between<br>2-3<br>years | Between<br>4-5<br>years | After<br>5 years |
|                          | -----                  | -----                  | -----                   | -----                   | -----            |
| Long-term debt (1) ..... | \$ 45.1                | \$ 23.4                | \$ 3.9                  | \$ 17.8                 | \$ --            |
| Operating leases .....   | 9.2                    | 1.5                    | 2.5                     | 2.5                     | 2.7              |
| Minimum royalties .....  | 14.6                   | 5.1                    | 3.5                     | 2.4                     | 3.6              |

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|   |          |         |         |         |         |
|---|----------|---------|---------|---------|---------|
| Purchase commitment .....               | 45.4     | 9.2     | 10.0    | 10.0    | 16.2    |
|   | -----    | -----   | -----   | -----   | -----   |
| Total Contractual Cash Obligations .... | \$ 114.3 | \$ 39.2 | \$ 19.9 | \$ 32.7 | \$ 22.5 |

(1) Includes interest on long-term debt obligations. Based on outstanding borrowings as of September 30, 2006, 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 \$9.8 million.

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| COMMERCIAL COMMITMENTS<br>AVAILABLE TO US           | TOTAL<br>AMOUNTS<br>COMMITTED<br>TO US | AMOUNT OF COMMITMENT EXPIRATION PER PERIOD |                          |                          |                  |
|---|--|--|--------------------------|--------------------------|------------------|
|   |  | LESS<br>THAN<br>1 YEAR                     | BETWEEN<br>2 -3<br>YEARS | BETWEEN<br>4 -5<br>YEARS | AFTER<br>5 YEARS |
| Lines of credit .....                               | \$ 80.0                                | \$ 80.0                                    | \$ --                    | \$ --                    | \$ --            |
| Letters of credit (within lines of<br>credit) ..... | \$ 25.0                                | \$ 25.0                                    | \$ --                    | \$ --                    | \$ --            |
| Total commercial commitments .....                  | \$ 80.0                                | \$ 80.0                                    | \$ --                    | \$ --                    | \$ --            |

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 could arrange for the issuance of letters of credit and acceptances. The facility was collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by us and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman and Interim Chief Executive Officer, also signed a guarantee of \$5 million in favor of UPS to secure this facility. 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. Additionally, Gerard Guez, our Chairman and Interim Chief Executive Officer, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. On June 9, 2006, we completed the pay-off of all remaining amounts due under the letter of credit facility with UPS. As a result of the payment of these obligations, the letter of credit facility was terminated and all collateral released. There was no prepayment penalty under this arrangement. As of September 30, 2006, \$0 was outstanding under this facility with UPS.

On December 31, 2004, our Hong Kong subsidiaries entered into a 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 was 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. Under the amended loan agreement, we were subject to restrictive financial covenants of maintaining tangible net worth of \$25 million at December 31, 2005 and the last day of each fiscal quarter thereafter. There was also a provision capping maximum capital expenditure per quarter at \$800,000. The obligations under the loan agreement were collateralized by the same security interests and

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guarantees provided under our letter of credit facility with UPS. Additionally, the term loan was 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 and Interim Chief Executive Officer, of 4.6 million shares of our common stock. On June 9, 2006, we completed the pay-off of all remaining amounts due under the term loan agreement with UPS. As a result of the payment of these obligations, the term loan agreement was terminated and all collateral released. There was no prepayment penalty under this arrangement.

Since March 2003, DBS Bank (Hong Kong) Limited ("DBS") had 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 was a demand facility and was secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, 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. In October 2005, a tax loan for HKD 6.233 million (equivalent to US \$804,000) was also made available to our Hong Kong subsidiaries and bears interest at the rate equal to the Hong Kong prime rate plus 1% and are subject to the same security. It bore interest at 9.25% per annum at September 30, 2006. As of September 30, 2006, \$70,000 was outstanding under this tax loan.

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS. Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries may borrow under this facility at any time is US \$25 million. The interest rate under the letter of credit facility is equal to the Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which the interest rate was 8.75% per annum at September 30, 2006, or the Standard Bills Rate quoted by DBS plus 0.5% if paid in any other currency, which the interest rate was 8.6% per annum at September 30, 2006. This is a demand facility and is secured by a security interest in all the assets of the Hong Kong subsidiaries, by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject

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to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2006, interest coverage ratio, leverage ratio and limitations on additional indebtedness. As of September 30, 2006, \$12.3 million was outstanding under this facility. In addition, \$4.7 million of open letters of credit was outstanding and \$8.0 million was available for future borrowings as of September 30, 2006.

As of September 30, 2006, the total balance outstanding under the DBS credit facilities was \$12.4 million (classified above as follows: \$4.5 million in import trade bills payable, \$3.8 million in bank direct acceptances and \$4.1 million in other Hong Kong credit facilities).

On October 1, 2004, we amended and restated our previously existing credit facility with GMAC Commercial Finance Credit, LLC ("GMAC CF") by entering into a new factoring agreement with GMAC CF. 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

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agreement with GMAC CF. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC CF, 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 CF, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC CF has the risk of loss and (b) \$40 million, minus in each case, any amount owed by us to GMAC CF. In May 2005, we amended our factoring agreement with GMAC CF to permit our subsidiaries party thereto and us, to borrow up to the lesser of \$3 million or 50% of the value of eligible inventory. In connection with this amendment, we granted GMAC CF a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC CF to increase the amount we may borrow against inventory to the lesser of \$5 million or 50% of the value of eligible inventory. The \$5 million limit was reduced to \$4 million on April 1, 2006.

On June 16, 2006, we expanded our credit facility with GMAC CF by entering into a new Loan and Security Agreement and amending and restating our previously existing Factoring Agreement with GMAC CF. UPS Capital Corporation is also a lender under the Loan and Security Agreement. This is a revolving credit facility and has a term of 3 years. The amount we may borrow under this credit facility is determined by a percentage of eligible accounts receivable and inventory, up to a maximum of \$55 million, and includes a letter of credit facility of up to \$4 million. Interest on outstanding amounts under this credit facility is payable monthly and accrues at the rate of the "prime rate" plus 0.5%. Our obligations under the GMAC CF credit facility are secured by a lien on substantially all our domestic assets, including a first priority lien on our accounts receivable and inventory. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness. This facility includes customary default provisions, and all outstanding obligations may become immediately due and payable in the event of a default. The facility bore interest at 8.75% per annum at September 30, 2006. As of September 30, 2006, we were in violation with the EBITDA covenant and a waiver was obtained during the default. A total of \$19.7 million was outstanding with respect to receivables factored under the GMAC CF facility at September 30, 2006.

The credit facilities with GMAC CF and Guggenheim include cross-default clauses subject to certain conditions. An event of default under the GMAC CF facility would constitute an event of default under the Guggenheim facility entitling Guggenheim to demand payment in full of all outstanding amounts under its facility. An event of default under the Guggenheim facility, under circumstances where Guggenheim has accelerated the debt or has exercised any other remedy available to Guggenheim which constitutes a Lien Enforcement Action under its Intercreditor Agreement with GMAC CF, would entitle GMAC CF to demand payment in full of all outstanding amounts under its debt facilities.

The amount we can borrow under the factoring facility with GMAC CF 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.

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On June 16, 2006, we entered into a Credit Agreement with certain lenders and Guggenheim Corporate Funding LLC ("Guggenheim"), as administrative agent and collateral agent for the lenders. This credit facility provides for borrowings of up to \$65 million. This facility consists of an initial term loan of up to \$25 million, of which we borrowed \$15.5 million at the initial funding, to be used to repay certain existing indebtedness and fund general operating and working capital needs. An additional term loan of up to \$40 million will be available under this facility to finance acquisitions acceptable to Guggenheim. All amounts under the term loans become due and payable in December 2010. Interest under this facility is payable monthly, with the interest rate equal to the LIBOR rate plus an applicable margin based on our debt leverage ratio (as defined in the credit agreement). Our obligations under the Guggenheim credit facility are secured by a lien on substantially all of our assets and our domestic subsidiaries, including a pledge of the equity interests of our domestic subsidiaries and 65% of our Luxembourg subsidiary. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness.

In connection with Guggenheim credit facility, on June 16, 2006, we issued the lenders under this facility warrants to purchase up to an aggregate of 3,857,143 shares of our common stock. These warrants have a term of 10 years. These warrants are exercisable at a price of \$1.88 per share with respect to 20% of the shares, \$2.00 per share with respect to 20% of the shares, \$3.00 per share with respect to 20% of the shares, \$3.75 per share with respect to 20% of the shares and \$4.50 per share with respect to 20% of the shares. The exercise prices are subject to adjustment for certain dilutive issuances pursuant to the terms of the warrants. 357,143 shares of the warrants will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at \$4.9 million using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. We also paid to Guggenheim 2.25% of the committed principal amount of the loans which was \$563,000 on June 16, 2006. The \$563,000 fee paid to Guggenheim is included in the deferred financing cost, and the value of the warrants to purchase 3.5 million shares of our common stock of \$4.9 million is recorded as debt discount, both of them are amortized over the life of the loan. As of September 30, 2006, \$352,000 was amortized.

Durham Capital Corporation acted as our advisor in connection with the Guggenheim credit facility. As compensation for its services, we agreed to pay Durham Capital a cash fee in an amount equal to 1% of the committed principal amount of the loans under the Guggenheim credit facility. As a result, \$250,000 was paid on June 16, 2006. In addition, we issued Durham Capital a warrant to purchase 77,143 shares of our common stock. This warrant has a term of 10 years and is exercisable at a price of \$1.88 per share, subject to adjustment for certain dilutive issuances. 7,143 shares of this warrant will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at \$105,000 using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. The \$250,000 fee paid to Durham Capital and the value of the warrants to purchase 70,000 shares of our common stock of \$105,000 is included in the deferred financing cost, and is amortized over the life of

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the loan. As of September 30, 2006, \$23,000 was amortized.

The Guggenheim facility bore interest at 12.33% per annum at September 30, 2006. As of September 30, 2006, we were in violation with the EBITDA covenant and a waiver was obtained during the default. A total of \$10.9 million, net of \$4.6 million of debt discount, was outstanding under this facility at September 30, 2006.

As of June 30, 2006, the warrants were being accounted for as a liability pursuant to the provisions of SFAS No. 133 and Emerging Issues Task Force ("EITF") No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19"). This is because we granted the warrant holders certain registration rights that are outside our control. In accordance with SFAS No. 133, the warrants are being valued at each reporting period. Changes in fair value are recorded as adjustment to fair value of derivative in the statements of operations. The outstanding warrants were fair valued on June 16, 2006, the date of the transaction, at \$5.0 million and we, in accordance with SFAS 133, re-evaluated the warrants on June 30, 2006 at

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the closing stock price on June 30, 2006 to \$5.2 million; as a result, an expense of \$218,000 was recorded as an adjustment to fair value of derivative on our consolidated statements of operations. On August 11, 2006, the registration rights agreement relating to the warrants was amended to provide that if we were unable to file or have the registration statement declared effective by the required deadlines, we would be required to pay the warrant holders cash payments as partial liquidated damages each month until the registration statement was filed and/or declared effective. The liquidated damages payable by us to the warrant holders are limited to 20% of the purchase price of the shares underlying the warrants, which we determined to be a reasonable discount for restricted stock as compared to registered stock. As a result of amending the registration rights relating to the warrants on August 11, 2006, the warrants were reclassified from debt to equity in accordance with EITF 00-19 in the third quarter of 2006. The outstanding warrants were revalued on August 11, 2006 at the closing stock price on August 11, 2006 to \$4.5 million; as a result, income of \$729,000 was recorded as an adjustment to fair value of derivative on our consolidated statements of operations.

On December 14, 2004, we completed a \$10 million financing through the issuance of (i) 6% Secured Convertible Debentures and (ii) warrants to purchase up to 1,250,000 shares of our common stock. Prior to maturity, the investors may convert the convertible 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 convertible 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 convertible 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 convertible 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 convertible 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 debentures were thus valued at

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\$8,996,000, resulting in an effective conversion price of \$1.799 per share. The intrinsic value of the conversion option of \$804,000 was 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 financing cost paid to the placement agent of \$620,000, and the value of the warrants to purchase 200,000 shares of our common stock of \$138,000 were included in the deferred financing cost, net on our accompanying balance sheets and was amortized over the life of the loan.

In June 2005, holders of our convertible debentures converted an aggregate of \$2.3 million of convertible debentures into 1,133,687 shares of our common stock. In August 2005, holders of our convertible debentures converted an aggregate of \$820,000 of convertible debentures into 410,000 shares of our common stock. These convertible 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 2006 was \$237,000. Total deferred financing cost amortized in the first nine months of 2006 was \$95,000. Total interest paid to the holders of the convertible debentures in the first nine months of 2006 was \$198,000. On June 26, 2006, we paid off the remaining balance of the outstanding convertible debentures of \$6.9 million plus all accrued and unpaid interest and a prepayment penalty of \$171,000. As a result of the repayment, the convertible debentures were terminated effective June 26, 2006. Upon paying off the convertible debentures, debt discount of \$278,000 related to the intrinsic value of the conversion option of \$804,000 was expensed, and of the \$620,000 financing cost paid to the placement agent, \$214,000 was expensed. The remaining value of the warrants to holders of the convertible debentures of \$433,000 and warrants to the placement agent of \$69,000 was also expensed.

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On January 19, 2006, we borrowed \$4.0 million from Max Azria pursuant to the terms of a promissory note, which amount bore interest at the rate of 5.5% per annum and was payable in weekly installments of \$200,000 beginning on March 1, 2006. This was an unsecured loan. We paid off the remaining balance of this loan in July 2006.

We had three equipment loans outstanding at December 31, 2005. One of these equipment loans bore interest at 6% payable in installments through 2009, which we paid off in January 2006. The second loan bears interest at 15.8% payable in installment through 2007 and the third loan bears interest at 6.15% payable in installment through 2007. In August 2006, we entered into a new auto loan that bears interest at 4.75% payable in installment through 2008. As of September 30, 2006, \$46,000 was outstanding under the three remaining loans.

From time to time, we open letters of credit under an uncommitted line



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of credit from Aurora Capital Associates which issues these letters of credits out of Israeli Discount Bank. As of September 30, 2006, \$164,000 was outstanding under this facility (classified above under import trade bills payable) and \$1.0 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, and sales of equity and debt security. Our short-term funding relies very heavily on our major customers, banks, and suppliers. 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 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, 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, to borrow additional funds under our bank facilities 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 \$7.7 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.

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 executive offices in Los Angeles, California from GET, a corporation which is owned by Gerard Guez (our Chairman and Interim Chief Executive Officer) and Todd Kay (our Vice Chairman), both of which are significant shareholders. Additionally, we lease our warehouse and office space in Hong Kong from Lynx

International Limited, a Hong Kong corporation that is owned by Messrs. Guez and Kay. We paid \$807,000 and \$764,000 in rent in the nine months ended September 30, 2006 and 2005, respectively, for office and warehouse facilities. During the first seven months of 2006, our Los Angeles offices and warehouse was leased on a month to month basis. On August 1, 2006, we entered into a lease agreement with GET for the Los Angeles offices and warehouse, which lease has a term of five years with an option to renew for an additional five year term. On January 1, 2006, we renewed our lease agreement with Lynx International Limited for our office space in Hong Kong for one year.

On May 1, 2006, we sublet our executive office in Los Angeles, California and our sales office in New York to Seven Licensing Company, LLC ("Seven Licensing") for a monthly payment of \$25,000 on a month to month basis. Seven Licensing is beneficially owned by Gerard Guez, our Chairman and Interim Chief Executive Officer. We received \$125,000 in rental income from this sublease in the nine months ended September 30, 2006.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing to be its buying agent to source and purchase apparel merchandises.

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, 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 \$41.0 million notes receivable - related party on the accompanying balance sheet as of September 30, 2006 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Historically, we have placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we have satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, the purchasers have recently ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately \$27.1 million, resulting in a notes receivable balance at September 30, 2006 of approximately \$14 million. We will continue to pursue payments on the notes receivable and believe the remaining \$14 million balance at September 30, 2006 is realizable. 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 \$0 and \$4.1 million of fabric from Acabados y Terminados in the nine months ended September 30, 2006 and 2005, respectively. In addition to the notes receivable, net amount due from these parties as of September 30, 2006 was \$412,000, related to reimbursement expenses.

From time to time in the past, we borrowed funds from, and advanced

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funds to, Mr. Guez. The greatest outstanding balance of such advances to Mr. Guez in the third quarter of 2006 was approximately \$2,234,000. At September 30, 2006, the entire balance due from Mr. Guez totaling \$2.2 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All advances to Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$129,000 and \$165,000 for the nine months ended September 30, 2006 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately \$226,000 and \$321,000 for the nine months ended September 30, 2006 and 2005, 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.

At September 30, 2006, we had various employee receivables totaling \$258,000 included in due from related parties.

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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"), a corporation owned by the brothers of Gerard Guez, our Chairman and Interim Chief Executive Officer, called United Apparel Ventures, LLC. 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.

At September 30, 2006, Messrs. Guez and Kay beneficially owned 590,000 and 1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc., collectively representing approximately 8.7% of Tag-It Pacific's common stock. Tag-It Pacific is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Starting from 1998, Tag-It Pacific 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 Pacific no longer manages our trim and packaging requirements. We purchased \$205,000 and \$55,000 of trim inventory from Tag-It Pacific in the nine months ended September 30, 2006 and 2005, respectively. Our sales of garment accessories to Tag-It Pacific were \$39,000 and \$0 in the nine months ended September 30, 2006 and 2005, respectively. We purchased \$0 and \$135,000 of finished goods and services from Azteca and its affiliates in the nine months ended September 30, 2006 and 2005, respectively. Our sales of fabric and services to Azteca in the nine months ended September 30, 2006 and 2005 was \$9,000 and \$63,000, respectively. Net amount due from these related parties as of September 30, 2006 was \$5.5 million.

We believe that 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

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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.

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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. At times we use forward exchange contracts to reduce the effect of fluctuations of foreign currencies on purchases and commitments. These short-term assets and commitments are principally related to trade payables positions. We do not utilize derivative financial instruments for trading or other speculative purposes. We actively evaluate the creditworthiness of the financial institutions that are counter parties to derivative financial instruments, and we do not expect any counter parties to fail to meet their obligations.

**INTEREST RATE RISK.** Because our obligations under our various credit agreements bear interest at floating 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 our 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, 2006, the end of the period covered by this report. Members of the our management, including our Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the further quarter of 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. 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

There were no significant changes in our internal controls or in other factors that could significantly affect internal controls, known to the Chief Executive Officer or the Chief Financial Officer during the third quarter of 2006.

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### PART II -- OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS.

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands (captioned Tarrant Apparel Group v. Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson) in the Supreme Court of the State of New York, County of New York. The suit named Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson as defendants, and asserts that the defendants failed to provide promised support in connection with our sublicense agreement for the Jessica Simpson brands. Our complaint includes eight causes of action, including two seeking a declaration that the sublicense agreement is exclusive and remains in full force and effect, as well as claims for breach of contract by Camuto Consulting, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto Consulting, and a claim against With You, Inc. and Ms. Simpson that we are an intended third party beneficiary of the licenses between those defendants and Camuto Consulting. On or about April 26, 2006, Camuto Consulting served its answer to our complaint and included a counterclaim against us for breach of the sublicense agreement and alleging damages of no less than \$100 million. Camuto Consulting has also served a motion to dismiss our cause of action for fraudulent inducement. On or about May 22, 2006, we served our reply to Camuto Consulting's counterclaim. On or about April 27, 2006, Ms. Simpson served a motion seeking dismissal of the cause of action asserted against her. On or about May 10, 2006, we served our opposition to Ms. Simpson motion to dismiss. On or about June 14, 2006, we served a cross-motion seeking leave to amend our complaint to add Vincent Camuto as a defendant. On October 18, 2006, the Court: (i) granted our cross-motion seeking leave to file a supplemental summons and amended complaint adding Vincent Camuto as a defendant and supplementing the allegations of fraud against Camuto Consulting; (ii) denied Camuto Consulting's motion to dismiss the cause of action for fraudulent inducement; and (iii) denied Ms. Simpson's motion to dismiss the cause of action asserted against her. On or about October 30, 2006, Camuto Consulting and Vincent Camuto served their answer to the amended complaint, with a counterclaim that is virtually identical to the original counterclaim. We intend to continue to vigorously defend Camuto's counterclaim and vigorously oppose Ms. Simpson's motion. Discovery in the matter has been underway since May 2006. A status conference is scheduled before the Court on November 21, 2006.

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 1A. RISK FACTORS.

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.

Five customers accounted for approximately 64% and 48% of our net sales in first nine months of 2006 and 2005, respectively. We believe that

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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

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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. 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 affect our results of operations.

UNPREDICTABLE DELAYS AS THE RESULT OF INCREASED AND INTENSIFIED CUSTOMS ACTIVITY.

U.S. Customs has stepped up efforts to scrutinize imports from Hong Kong in order to verify all details of shipments under the OPA rules allowing certain processes to be performed in China without shipping under China country of origin documentation. Such "detentions" are unpredictable and cause serious interruption of normally expected freight movement timetables.

THE OUTCOME OF LITIGATION IN WHICH WE ARE INVOLVED IS UNPREDICTABLE AND AN ADVERSE DECISION IN ANY SUCH MATTER COULD HAVE A MATERIAL ADVERSE AFFECT ON OUR FINANCIAL POSITION AND RESULTS OF OPERATIONS.

We are currently in litigation with the licensors of the Jessica Simpson brands regarding our rights to sell apparel under these brands. See Part II of this report, Item 1 "Legal Proceedings" for a detailed description of this

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lawsuit. The licensor has filed a counterclaim against us seeking damage. These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made against us, and intend to contest the lawsuit vigorously, no assurances can be given that the results of these matters will be favorable to us. An adverse resolution of any of these lawsuits could have a material adverse affect on our financial position and results of operations. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

### 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.

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

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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.

### 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.

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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 cash on hand and cash available through our bank credit facilities, issuance of long-term debt and 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 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. Actions taken to avoid these measures caused disruption, and a negative impact on margins. Such disruption may continue to affect us to some extent in the future.

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



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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, 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 DEPENDENCE ON THIRD PARTIES FOR BRANDED APPAREL PRODUCTS REDUCES OUR ABILITY TO CONTROL THE MARKETING PROCESS, WHICH COULD HARM OUR SALES, REPUTATION AND OVERALL PROFITABILITY.

For certain branded apparel lines, in particular celebrity brands, we depend on the cooperation and efforts of the celebrity personality and/or master licensor to support our design and marketing efforts for apparel products. A celebrity's failure to adequately support our marketing efforts could adversely affect the sales for new products and lines. In addition, we are subject to the terms of our agreements with the master licensor for licensed brands, and our rights to exploit certain brands may therefore be limited. Further, we may, from time to time, become involved in disputes with the master licensor with respect to our contractual relationship. To the extent we are not able to receive adequate support from the master licensor and/or celebrity or maintain good working relationships with master licensors, our business would be harmed.

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

Approximately 81% of our products were imported from outside the U.S. in fiscal 2005. 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

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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.

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

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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 \$7.7 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, 2006, our executive officers and directors and their affiliates owned approximately 43% of the outstanding shares of our common stock. Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman, alone own approximately 33.1% and 8.4%, respectively, of the outstanding shares of our common stock at September 30, 2006. 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.

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OUR STOCK PRICE HAS BEEN VOLATILE.

Our common stock is quoted on the NASDAQ Global Market, 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.

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 6. EXHIBITS.

| Exhibit<br>Number | Description   |
|-------------------|---|
| 10.39.1           | Amendment No. 1 to Credit Agreement, dated July 5, 2006, by and among Tarrant Apparel Group, Fashion Resource (TCL), Inc., Tag Mex, Inc., United Apparel Ventures, LLC, Private Brands, Inc. and NO! Jeans, Inc., the Guarantor a party thereto, the Lenders a party thereto and Guggenheim Corporate Funding, LLC. |
| 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   |

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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, 2006

By: /s/ Corazon Reyes

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Corazon Reyes,  
Chief Financial Officer

Date: November 14, 2006

By: /s/ Gerard Guez

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Gerard Guez,  
Interim Chief Executive Officer

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