TARRANT APPAREL GROUP
Form 10-K/A
October 11, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K/A
AMENDMENT NO. 2

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

For the fiscal year ended December 31, 2005

or

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

For the transition period from ______ to _______

Commission File Number: 0-26006

TARRANT APPAREL GROUP
(Exact name of registrant as specified in its charter)

CALIFORNIA	95-4181026
(State or other jurisdiction of incorporation or organization)	(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

Securities registered pursuant to Section 12(b) of the Act:

NONE

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registration is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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 [X] No [_]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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 [X]

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

The aggregate market value of the Common Stock held by non-affiliates of the Registrant is approximately $51,515,376 based upon the closing price of the Common Stock on June 30, 2005.

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

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2006 Annual Meeting of Shareholders are incorporated by reference into Part III of this Report.

EXPLANATORY NOTE

We are filing this Amendment No. 2 to Annual Report on Form 10-K/A for the year ended December 31, 2005 (the "Amended Annual Report"), to amend our Annual Report on Form 10-K for the year ended December 31, 2005 originally filed with the Securities and Exchange Commission (the "SEC") on March 31, 2006 and previously amended by our Annual Report on Form 10-K/A filed with the SEC on January 31, 2007 (as amended, the "Original Annual Report"). The Company is filing this Amended Annual Report in response to comments received from the SEC. The following Items amend the Original Annual Report, as permitted by the rules and regulations of the SEC. Unless otherwise stated, all information contained in this Amended Annual Report is as of March 31, 2006. All capitalized terms used herein but not otherwise defined shall have the meanings ascribed to them in the Original Annual Report.

PART II

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See "Item 15. Exhibits, Financial Statement Schedules" for our financial statements, and the notes thereto, and the financial statement schedules filed as part of this report.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Financial Statements and Schedule. Reference is made to the Index to Financial Statements and Schedule on page F-1 for a list of financial statements and the financial statement schedule filed as part of this report.

All other schedules are omitted because they are not applicable or the required information is shown in the Company's financial statements or the related notes thereto.

(b) Exhibits.

EXHIBIT NUMBER	DESCRIPTION
23.1	Consent of Singer Lewak Greenbaum & Goldstein LLP.
23.2	Consent of Grant Thornton LLP.
23.3	Consent of Singer Lewak Greenbaum & Goldstein LLP.
31.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
31.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
32.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
32.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.

INDEX TO FINANCIAL STATEMENTS AND SCHEDULE

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Tarrant Apparel Group
Los Angeles, California

We have audited the consolidated balance sheet of Tarrant Apparel Group and subsidiaries (collectively, the "Company") as of December 31, 2005, and the related consolidated statement of operations, stockholders' equity and cash flows for the year then ended. Our audit also included the financial statement schedule of Tarrant Apparel Group, listed in Item 15(a). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Tarrant Apparel Group and subsidiaries as of December 31, 2005, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements, taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Singer Lewak Greenbaum & Goldstein LLP

SINGER LEWAK GREENBAUM & GOLDSTEIN LLP

Los Angeles, California

March 15, 2006, except for Note 6,
as to which the date is October 3, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and
Shareholders of Tarrant Apparel Group

We have audited the accompanying consolidated balance sheet of Tarrant Apparel Group (a California corporation) and subsidiaries as of December 31, 2004 and the related consolidated statements of operations and comprehensive loss, shareholders' equity, and cash flows for each of the two years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tarrant Apparel Group as of December 31, 2004 and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

We have also audited Schedule II of Tarrant Apparel Group for each of the two years in the period ending December 31, 2004. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth therein.

/S/ GRANT THORNTON LLP

Grant Thornton LLP

Los Angeles, California
March 24, 2005, except for Note 19,
as to which the date is March 30, 2005, and
Note 13, as to which the date is May 31, 2005

TARRANT APPAREL GROUP

CONSOLIDATED BALANCE SHEETS

DECEMBER 31,

	2004	2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,214,944	$ 1,641
Accounts receivable, net	37,759,343	54,598
Due from related parties	10,651,914	3,100
Inventory	19,144,105	31,628
Current portion of note receivable from related party	5,323,733	5,139
Prepaid expenses	1,251,684	1,292
Prepaid royalties	2,257,985	1,123
Income taxes receivable	144,796	25
Total current assets	77,748,504	98,550
Property and equipment, net	1,874,893	1,702
Notes receivable - related party, net of current portion	40,107,337	36,268
Due from related parties	--	2,994
Equity method investment	1,880,281	2,138
Deferred financing cost, net	1,203,259	838
Other assets	414,161	164
Goodwill, net	8,582,845	8,582
Total assets	$ 131,811,280	$ 151,242
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term bank borrowings	$ 17,951,157	$ 13,833
Accounts payable	24,394,553	33,278
Accrued expenses	11,243,179	9,503
Income taxes	16,826,383	16,828
Current portion of long-term obligations and factoring arrangement	19,628,701	36,109
Total current liabilities	90,043,973	109,554
Long-term obligations	2,544,546	239
Convertible debentures, net	8,330,483	5,965
Deferred tax liabilities	213,784	47
Minority interest in PBG7	--	75
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized; no shares (2004) and no shares (2005) issued and outstanding	--	
Common stock, no par value, 100,000,000 shares authorized; 28,814,763 shares (2004) and 30,553,763 shares (2005) issued and outstanding	111,515,091	114,977
Warrant to purchase common stock	2,846,833	2,846
Contributed capital	9,965,591	10,004
Accumulated deficit	(91,182,959)	(90,189
Notes receivable from officer/shareholder	(2,466,062)	(2,278
Total shareholders' equity	30,678,494	35,360

Total liabilities and shareholders' equity	$ 131,811,280	$ 151,242

See accompanying notes.

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Net sales	$ 320,422,850	$ 155,452,663	$ 214,648,218
Cost of sales	288,445,173	134,492,460	169,767,051
Gross profit	31,977,677	20,960,203	44,881,167
Selling and distribution expenses	11,329,414	9,290,819	10,726,425
General and administrative expenses	31,767,122	32,083,637	26,864,789
Write-off of prepaid expenses	2,771,989	--	--
Royalty expense	242,426	604,888	3,664,454
Impairment charges	19,504,521	77,982,034	--
Cumulative translation loss attributable to liquidated Mexico operations	--	22,786,125	--
Income (loss) from operations	(33,637,795)	(121,787,300)	3,625,499
Interest expense	(5,602,556)	(2,857,096)	(4,624,590)
Interest income	424,518	377,587	2,081,456
Minority interest	3,461,243	15,331,171	(75,241)
Interest in income of equity method investee..	--	769,706	559,634
Other income	4,784,479	6,366,637	354,347
Other expense	(1,182,920)	(529,257)	(580)
Income (loss) before provision for income taxes	(31,753,031)	(102,328,552)	1,920,525
Provision for income taxes	4,131,629	2,348,119	927,181
Net income (loss)	$ (35,884,660)	$(104,676,671)	$ 993,344
Net income (loss) per share - Basic (as restated, see Note 13):	$ (2.38)	$ (3.64)	$ 0.03
Net income (loss) per share - Diluted (as restated, see Note 13)	$ (2.38)	$ (3.64)	$ 0.03

Weighted average common and common equivalent shares outstanding:			
Basic	18,215,071	28,732,796	29,728,997
Diluted	18,215,071	28,732,796	29,734,291
Net income (loss)	$ (35,884,660)	$(104,676,671)	$ 993,344
Foreign currency translation adjustment	(9,945,727)	--	--
Total comprehensive income (loss)	$ (45,830,387)	$(104,676,671)	$ 993,344

See accompanying notes.

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2003, 2004 AND 2005

	PREFERRED STOCK	NUMBER OF SHARES	COMMON STOCK
Balance at January 1, 2003	$ 8,820,573	100,000	$ 69,368,239
Net loss	--	--	--
Currency translation	--	--	--
Comprehensive loss	--	--	--
Conversion of preferred stock to common stock	(8,820,573)	(100,000)	8,820,573
Issuance of preferred stock and warrant, net	29,226,041	881,732	--
Conversion of preferred stock to common stock	(29,226,041)	(881,732)	29,226,041
Intrinsic value of beneficial conversion associated with convertible preferred stock	--	--	--
Issuance of common stock	--	--	788,000
Retirement of stock	--	--	(311,427)
Compensation expense	--	--	--
Repayment from shareholders	--	--	--
Balance at December 31, 2003 (as restated, see Note 13)	--	--	107,891,426
Currency translation	--	--	--
Net loss	--	--	--
Cumulative translation loss attributable to liquidated Mexico operations	--	--	--
Compensation expense	--	--	--

Issuance of common stock	--	--	3,623,665
Issuance of warrants with debentures	--	--	--
Intrinsic value of beneficial conversion associated with convertible debentures	--	--	--
Repayment from shareholders	--	--	--
Reclassification of shareholders' receivable to current asset	--	--	--
Balance at December 31, 2004	$ --	--	$ 111,515,091
Net income	--	--	--
Compensation expense	--	--	--
Issuance of common stock	--	--	375,000
Conversion of debentures	--	--	3,087,374
Repayment from shareholders	--	--	--
Balance at December 31, 2005	$ --	--	$ 114,977,465

	CONTRIBUTED CAPITAL	RETAINED EARNINGS (ACCUMULATED DEFICIT)	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)
Balance at January 1, 2003	1,434,259	56,873,094	(9,733,458)
Net loss	--	(35,884,660)	--
Currency translation	--	--	(9,945,727)
Comprehensive loss	--	--	--
Conversion of preferred stock to common stock	--	--	--
Issuance of preferred stock and warrant, net	--	--	--
Conversion of preferred stock to common stock	--	--	--
Intrinsic value of beneficial conversion associated with convertible preferred stock	7,494,722	(7,494,722)	--
Issuance of common stock	--	--	--
Retirement of stock	--	--	--
Compensation expense	71,572	--	--
Repayment from shareholders	--	--	--
Balance at December 31, 2003 (as restated, see Note 13)	9,000,553	13,493,712	(19,679,185)
Currency translation	--	--	(3,106,940)
Net loss	--	(104,676,671)	--
Cumulative translation loss attributable to liquidated Mexico operations	--	--	22,786,125
Compensation expense	161,038	--	--
Issuance of common stock	--	--	--
Issuance of warrants with debentures	--	--	--
Intrinsic value of beneficial conversion associated with convertible debentures	804,000	--	--
Repayment from shareholders	--	--	--
Reclassification of shareholders' receivable to current asset	--	--	--

Balance at December 31, 2004	$ 9,965,591	$ (91,182,959)	$ --
Net income	--	993,344	--
Compensation expense	38,740	--	--
Issuance of common stock	--	--	--
Conversion of debentures	--	--	--
Repayment from shareholders	--	--	--
Balance at December 31, 2005	$ 10,004,331	$ (90,189,615)	$ --

See accompanying notes

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEAR ENDED DECEMBER	
	2003	2004
Operating activities:		
Net Income (loss)	$ (35,884,660)	$(104,676,671)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Deferred taxes	(132,622)	(61,345)
Depreciation and amortization	16,097,595	8,337,946
Receipt of merchandise in lieu of interest on notes receivable, related party	--	--
Impairment charges	22,276,510	77,982,034
Cumulative transaction loss attributable to the liquidated Mexico operations	--	22,786,125
Inventory write-down	10,986,153	--
Prepaid royalties write-off	--	--
Income from equity method investment	--	(769,706)
Loss (gain) on sale of fixed assets	593,626	(15,272)
Unrealized (gain) loss on foreign currency	560,602	(367,262)
Minority interest	(3,218,069)	(15,331,171)
Gain on legal settlement	(235,785)	--
Compensation expense related to stock options	71,572	161,038
Change in the provision for returns and discounts	(324,387)	(1,747,060)
Changes in operating assets and liabilities:		
Restricted cash	(2,759,742)	2,759,742
Accounts receivable	7,856,700	21,224,454
Due to/from related parties	(14,801,324)	(122,389)
Inventory	9,626,509	4,162,158
Prepaid expenses	590,046	(1,860,955)
Other assets	450,782	--
Accounts payable	(4,207,552)	687,758

Accrued expenses and income tax payable	2,388,976	(981,196)
Net cash (used in) provided by operating activities	9,934,930	12,168,228
Investing activities:		
Purchase of fixed assets	(368,113)	(111,836)
Proceeds from sale of fixed assets	209,788	1,219,904
Investment in equity investment method	(1,434,375)	(137,000)
Distribution from equity investment method	--	460,800
Collection on notes receivable, related party	--	--
Investment in joint venture	--	(211,963)
Collection of advances from shareholders/officers	88,723	30,366
Net cash provided by (used in) investing activities	(1,503,977)	1,250,271
Financing activities:		
Short-term bank borrowings, net	(161,194)	(11,342,166)
Proceeds from long-term obligations	239,280,109	129,667,084
Payment of financing costs	--	(1,124,668)
Payment of long-term obligations and bank borrowings	(275,640,677)	(146,375,987)
Repayments of borrowings from shareholders/officers	(486,379)	--
Proceeds from issuance of preferred stock and warrant	31,024,774	3,623,665
Proceeds from convertible debentures, net	--	10,000,000
Repurchase of shares	(311,427)	--
Net cash provided by (used in) financing activities	(6,294,794)	(15,552,072)
Effect of exchange rate on cash	(204,677)	28,553
Increase (decrease) in cash and cash equivalents	1,931,482	(2,105,020)
Cash and cash equivalents at beginning of year	1,388,482	3,319,964
Cash and cash equivalents at end of year	$ 3,319,964	$ 1,214,944

See accompanying notes

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION AND BASIS OF CONSOLIDATION

The accompanying financial statements consist of the consolidation of Tarrant Apparel Group, a California corporation, and its majority owned Subsidiaries located primarily in the U.S., Mexico, and Asia. At December 31, 2005, we own 50.1% of United Apparel Ventures ("UAV") and 75% of PBG7, LLC ("PBG7"). We consolidate these entities and reflect the minority interests in earnings (losses) of the ventures in the accompanying financial statements. All inter-company amounts are eliminated in consolidation. The 49.9% minority interest in UAV is owned by Azteca Production International, a corporation owned by the brothers of our Chairman, Gerard Guez. The 25% minority interest in PBG7 is owned by BH7, LLC, an unrelated party.

We serve specialty retail, mass merchandise and department store chains and major international brands by designing, merchandising, contracting for the manufacture of, and selling casual apparel for women, men and children under private label. Commencing in 1999, we expanded our operations from sourcing apparel to sourcing and operating our own vertically integrated manufacturing facilities. In August 2003, we determined to abandon our strategy of being both a trading and vertically integrated manufacturing company, and effective September 1, 2003, we leased and outsourced operation of our manufacturing facilities in Mexico to affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction. See Note 7 and Note 15 of the "Notes to Consolidated Financial Statements." In August 2004, we entered into a purchase and sale agreement to sell these facilities to affiliates of Mr. Nacif, which transaction consummated in the fourth quarter of 2004. See Note 5 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.

RISK AND UNCERTAINTIES - IRS EXAMINATION

As discussed in Note 10 of the "Notes to Consolidated Financial Statements," our federal income tax returns for the years ended December 31, 1996 through 2002 are under examination by the Internal Revenue Service ("IRS"). The IRS has proposed adjustments to increase our federal income tax payable for these years. This adjustment would also result in additional state taxes, penalties and interest. 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. 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. See Note 10 of the "Notes to Consolidated Financial Statements" for a further discussion on the IRS examination.

RISK AND UNCERTAINTIES - DEBT COVENANTS

As discussed in Note 8 of the "Notes to Consolidated Financial Statements," our debt agreements require certain covenants including a minimum level of net worth. 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 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, including 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. See Note 8 of the "Notes to Consolidated Financial Statements" for a further discussion of the credit facilities and related debt covenants.

REVENUE RECOGNITION

Revenue is recognized at the point of shipment for all merchandise sold based on FOB shipping point. For merchandise shipped on landed duty paid ("LDP") terms, revenue is recognized at the point of either leaving Customs for direct shipments or at the point of leaving our warehouse where title is transferred, net of an estimate of returned merchandise and discounts. Customers are allowed the rights of return or non-acceptance only upon receipt of damaged products or goods with quality different from shipment samples. We do not undertake any after-sale warranty or any form of price protection.

We often arrange, on behalf of manufacturers, for the purchase of fabric from a single supplier. We have the fabric shipped directly to the cutting factory and invoice the factory for the fabric. Generally, the factories pay us for the fabric with offsets against the price of the finished goods.

SHIPPING AND HANDLING COSTS

Freight charges are included in selling and distribution expenses in the statement of operations and amounted to $1,817,000, $783,000 and $667,000 for the years ended December 31, 2003, 2004 and 2005, respectively. We did not bill customers for shipping and handling costs for the years 2003 and 2004. In 2005, we did some billing for freight to specialty stores although the amount was not material.

CASH AND CASH EQUIVALENTS

Cash equivalents consist of cash and highly liquid investments with an original maturity of three months or less when purchased. Cash and cash equivalents held in foreign financial institutions totaled $1,206,000 and $1,062,000 as of December 31, 2004 and 2005, respectively. Cash is deposited with what we believe are highly credited quality financial institutions and may exceed FDIC insured limits.

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

We evaluate the collectibility of accounts receivable and chargebacks (disputes from the customer) based upon a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations (such as in the case of bankruptcy filings or substantial downgrading of credit sources), a specific reserve for bad debts is taken against amounts due to reduce the net recognized receivable to the amount reasonably expected to be collected. For all other customers, we recognize reserves for bad debts and uncollectible chargebacks based on our historical collection experience. If 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 December 31, 2004 and 2005, the balance of the allowance for returns, discounts and bad debts was $2.4 million and $3.0 million, respectively.

INVENTORIES

Inventories are stated (valued) at the lower of cost (first-in, first-out) 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.

COST OF SALES

Cost of sales includes costs related to product costs, direct labor, manufacturing overhead, duty, quota, freight in, and brokerage.

SELLING AND DISTRIBUTION EXPENSES

Selling and distribution expenses include expenses related to samples, travel and entertainment, salaries, rent, warehouse handling and other office expenses, professional fees, freight out, and selling commissions incurred in the sales process.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses include expenses related to research and product development, travel and entertainment, salaries, rent and other office expenses, depreciation and amortization, professional fees and bank charges.

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 a certain percentage of net sales. All of these agreements include minimum royalties. See Note 11 of the "Notes to Consolidated Financial Statements" regarding various agreements we have entered into.

PRODUCT DESIGN, ADVERTISING AND SALES PROMOTION COSTS

Product design, advertising and sales promotion costs are expensed as incurred. Product design, advertising and sales promotion costs included in selling, general and administrative expenses in the accompanying statements of operations (excluding the costs of manufacturing production samples) amounted to approximately $1,306,000, $2,106,000 and $3,009,000 in 2003, 2004 and 2005, respectively.

PROPERTY AND EQUIPMENT

Property and equipment is recorded at cost. Additions and betterments are capitalized while repair and maintenance costs are charged to operations as incurred. Depreciation of property and equipment is provided for by the straight-line method over their estimated useful lives. Leasehold improvements are amortized using the straight-line method over the lesser of their estimated useful lives or the term of the lease. Upon retirement or disposal of property and equipment, the cost and related accumulated depreciation are eliminated from the accounts and any gain or loss is reflected in the statement of operations. The estimated useful lives of the assets are as follows:

Buildings	35 to 40 years
Equipment	7 to 15 years
Furniture and Fixtures	5 to 7 years
Vehicles	5 years
Leasehold Improvements	Term of lease or Estimated useful life

IMPAIRMENT OF LONG-LIVED ASSETS

The carrying value of long-lived assets are reviewed when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If it is determined that an impairment loss has occurred based on the lowest level of identifiable expected future cash flow, then a loss is recognized in the statement of operations using a fair value based model.

VALUATION OF LONG-LIVED AND INTANGIBLE ASSETS AND GOODWILL

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. At December 31, 2005, we have a goodwill balance of $8.6 million, and a net property and equipment balance of $1.7 million, as compared to a goodwill balance of $8.6 million and a net property and equipment balance of $1.9 million at December 31, 2004. Our net property and equipment balance at December 31, 2004 reflects the disposal of our Mexico fixed assets of $123.3 million in the fourth quarter of 2004. See Note 5 and Note 7 of the "Notes to Consolidated Financial Statements."

Factors considered important that could trigger an impairment review include, but are not limited to, the following:

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

During the year ended December 31, 2005, we did not recognize any impairment related to goodwill and property and equipment.

DEFERRED FINANCING COST

Deferred financing costs were $1,203,000 and $839,000 at December 31, 2004 and 2005, respectively. These costs of obtaining financing and issuance of convertible debt instruments are being amortized on a straight-line basis over the term of the related debt. Amortization expenses for deferred charges were $408,000, $387,000 and $1,399,000 for the years ended December 31, 2003, 2004 and 2005, respectively.

INCOME TAXES

We utilize SFAS No. 109, "Accounting for Income Taxes," which prescribes the use of the liability method to compute the differences between the tax basis of assets and liabilities and the related financial reporting amounts using currently enacted tax laws and rates. A valuation allowance is recorded to reduce deferred taxes to the amount that is more likely than not to be realized.

Our Hong Kong corporate affiliates are taxed at an effective Hong Kong rate of 17.5%. As of December 31, 2005, no domestic tax provision has been provided for $41.9 million of un-remitted retained earnings of these Hong Kong corporations, as we intend to maintain these amounts outside of the U.S. on a permanent basis.

NET INCOME (LOSS) PER SHARE

Basic and diluted income (loss) per share has been computed in accordance with SFAS No. 128, "Earnings Per Share". A reconciliation of the numerator and denominator of basic loss per share and diluted loss per share is as follows:

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Basic EPS Computation:			
Numerator:			
Reported net income (loss)	$ (35,884,660)	$(104,676,671)	$ 993,344
Dividend to the preferred stockholders	(7,494,722)	--	--
Net income (loss) available to common stockholders	$ (43,379,382)	$(104,676,671)	$ 993,344
Denominator:			
Weighted average common shares outstanding..	18,215,071	28,732,796	29,728,997
Basic EPS	$ (2.38)	$ (3.64)	$ 0.03
Diluted EPS Computation:			
Numerator:			
Reported net income (loss)	$ (35,884,660)	$(104,676,671)	$ 993,344
Dividend to the preferred stockholders	(7,494,722)	--	--
Net income (loss) available to common stockholders	$ (43,379,382)	$(104,676,671)	$ 993,344

Denominator:			
Weighted average common shares outstanding..	18,215,071	28,732,796	29,728,997
Incremental shares from assumed exercise of			
warrants	--	--	--
convertible debentures	--	--	--
options	--	--	5,294
Total shares	18,215,071	28,732,796	29,734,291
Diluted EPS	$ (2.38)	$ (3.64)	$ 0.03

The following potentially dilutive securities were not included in the computation of loss per share, because to do so would have been anti-dilutive:

	2003	2004	2005
Options	8,926,087	8,331,962	6,727,756
Warrants	881,732	2,361,732	2,361,732
Convertible debentures	--	5,000,000	3,456,313
Total	9,807,819	15,693,694	12,545,801

DIVIDENDS

We did not declare or pay any cash dividends in 2003, 2004 or 2005. We intend to retain any future earnings for use in our business and, therefore, do not anticipate declaring or paying any cash dividends in the foreseeable future. The

declaration and payment of any cash dividends in the future will depend upon our earnings, financial condition, capital needs and other factors deemed relevant by the Board of Directors. In addition, our credit agreements prohibit the payment of dividends during the term of the agreements.

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of the Mexico and Hong Kong subsidiaries are translated at the rate of exchange in effect on the balance sheet date; income and expenses are translated at the average rates of exchange prevailing during the year. The functional currencies in which we transact business are the Hong Kong dollar and the peso in Mexico.

Foreign currency gains and losses resulting from translation of assets and liabilities are included in other comprehensive income (loss). Transaction gains or losses, other than inter-company debt deemed to be of a long-term nature, are included in net income (loss) in the period in which they occur. In 2004, we substantially liquidated our Mexico subsidiaries following the sale of the fixed assets in Mexico. The accumulated foreign currency translation adjustment related to the Mexico subsidiaries of $22.8 million of loss was reclassified and charged to income. The adjustment occurred in the fourth quarter of 2004. See Note 5 of the "Notes to Consolidated Financial Statements."

FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. Considerable judgment is required in estimating fair values. Accordingly, the estimates may not be indicative of the amounts that we could realize in a current market exchange. The carrying amounts of cash and cash equivalents, receivables and accounts payable approximate fair values. The carrying amounts of our variable rate borrowings under the various short-term borrowings and long-term debt arrangements approximate fair value.

CONCENTRATION OF CREDIT RISK

Financial instruments, which potentially expose us to concentration of credit risk, consist primarily of cash equivalents, trade accounts receivable, related party receivables and amounts due from factor.

Our products are primarily sold to mass merchandisers and specialty retail stores. These customers can be significantly affected by changes in economic, competitive or other factors. We make substantial sales to a relatively few, large customers. In order to minimize the risk of loss, we assign certain of our domestic accounts receivable to a factor without recourse or requires letters of credit from our customers prior to the shipment of goods. For non-factored receivables, account-monitoring procedures are utilized to minimize the risk of loss. Collateral is generally not required. At December 31, 2004 and 2005, approximately 19.6% and 22.5% of accounts receivable were due from two customers, respectively. The following table presents the percentage of net sales concentrated with certain customers.

	PERCENTAGE OF NET SALES		
CUSTOMER	2003	2004	2005
Kohl's	6.6	16.4	13.5
Macy's Merchandising Group	5.2	10.3	13.4
Mervyn's	5.9	15.4	11.2
Wal-Mart	8.7	5.9	11.1
Lerner New York	8.3	15.0	8.6
Lane Bryant	12.1	2.0	4.9
The Limited (1)	15.3	4.6	0.0

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(1) Includes Express and Limited stores.

We maintain demand deposits with several major banks. At times, cash balances may be in excess of Federal Deposit Insurance Corporation or equivalent foreign insurance limits.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates used by us in preparation of the financial statements include allowance for returns, discounts and bad debts, inventory, valuation of long-lived and intangible assets and goodwill, and tax provision. Actual results could differ from those estimates.

EMPLOYEE STOCK OPTIONS

We account for employee stock options using the intrinsic value method rather than the alternative fair-value accounting method. Under the intrinsic-value method, if the exercise price of the employee's stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. For the years ended December 31, 2003, 2004 and 2005, $72,000, $161,000 and $39,000 were recorded as an expense related to our stock options, respectively.

Pro forma information regarding net income and earnings per share is required by SFAS 148, and has been determined as if we had accounted for our employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions: weighted-average risk-free interest rate of 4% for 2003, 3% to 4% for 2004, 4% for 2005; dividend yields of 0% for 2003, 2004 and 2005; weighted-average volatility factors of the expected market price of our common stock of 0.65 for 2003, 0.51 to 0.55 for 2004 and 0.55 for 2005; and a weighted-average expected life of the option of four years for 2003, 2004 and 2005.

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

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

	2003	2004	2005
Net income (loss) as reported	$ (35,884,660)	$ (104,676,671)	$ 993,34
Add stock-based employee compensation charges reported in net loss	$ 71,572	$ 161,038	$ 38,74
Pro forma compensation expense, net of tax ..	$ (4,115,263)	$ (3,852,990)	$ (4,298,19
Pro forma net loss	$ (39,928,351)	$ (108,368,623)	$ (3,266,10
Net income (loss) per share			
Basic (as restated, see Note 13)	$ (2.38)	$ (3.64)	$ 0.0
Add stock-based employee compensation charges reported in net loss			
Basic	$ 0.00	$ 0.01	$ 0.0
Pro forma compensation expense per share			
Basic	$ (0.22)	$ (0.14)	$ (0.1

Pro forma loss per share			
Basic (as restated, see Note 13)	$ (2.60)	$ (3.77)	$ (0.1
Net income (loss) per share			
Diluted (as restated, see Note 13)	$ (2.38)	$ (3.64)	$ 0.0
Add stock-based employee compensation charges reported in net loss			
Diluted	$ 0.00	$ 0.01	$ 0.0
Pro forma compensation expense per share			
Diluted	$ (0.22)	$ (0.14)	$ (0.1
Pro forma loss per share			
Diluted (as restated, see Note 13)	$ (2.60)	$ (3.77)	$ (0.1

OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) includes all changes in equity (net assets) from non-owner sources such as foreign currency translation adjustments. We account for other comprehensive income (loss) in accordance with SFAS 130, "Reporting Comprehensive Income."

IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which addresses the accounting for employee stock options. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25 and generally would require instead that such transactions be accounted for using a fair value-based method. SFAS No. 123R also requires that tax benefits associated with these share-based payments be classified as financing activities in the statement of cash flow rather than operating activities as currently permitted. SFAS No. 123R is effective as of the beginning of our first annual or interim reporting period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission adopted a new rule amending the effective date for Statement 123R for public companies. Under the effective date provisions included in Statement 123R, registrants would have been required to implement the Statement's requirements as of the beginning of the first interim or annual period beginning after June 15, 2005, or after December 15, 2005 for small business issuers. The new rule allows registrants to implement Statement 123R at the beginning of their next fiscal year, instead of the next interim period, that begins after June 15, 2005. SFAS No. 123R offers alternative methods of adopting this final rule. We have not yet determined which alternative method we will use. We have not completed the process of evaluating the impact that will result from adopting SFAS No. 123R, but believe the impact upon adoption will be an increase to compensation expense.

In May 2005, the FASB issued SFAS No. 154, "Accounting for Changes and Error Corrections." SFAS 154 establishes standards for the accounting and reporting for changes in accounting principles. SFAS 154 replaces APB 20 "Accounting Changes" and FASB Interpretation No. 20 ("FIN 20"), "Reporting Accounting

Changes under AICPA Statements of Position." The Statement requires retrospective application for changes in accounting principle, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement would require that the new accounting policy be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for the period. When it is impracticable for an entity to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement would require the new accounting principle to be applied as if it were made prospectively from the earliest date practicable. SFAS 154 is effective as of the beginning of our first annual reporting period that begins after December 15, 2005. The adoption of this new accounting pronouncement is not expected to have a material impact on our consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments", which amends SFAS No. 133, "Accounting for Derivatives Instruments and Hedging Activities" and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." SFAS 155 amends SFAS 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS 155 also amends SFAS 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. We are currently evaluating the impact this new Standard, but believe that it will not have a material impact on our financial position, results of operations or cash flows.

CURRENCY RATE HEDGING

We manufacture in a number of countries throughout the world, including Hong Kong, and, as a result, are exposed to movements in foreign currency exchange rates. Periodically we will enter into various currency rate hedges. The primary purpose of our foreign currency hedging activities is to manage the volatility associated with foreign currency purchases of materials and equipment in the normal course of business. We utilize forward exchange contracts with maturities of one to three months. We do not enter into derivative financial instruments for speculative or trading purposes. We enter into certain foreign currency derivative instruments that do not meet hedge accounting criteria. As a result, we mark to market all derivative instruments with the gain or loss included in other income and expense. See Note 18 of the "Notes to Consolidated Financial Statements." These instruments are intended to protect against exposure related to financing transactions (equipment) and income from international operations. There were no exchange contracts at December 31, 2004 and December 31, 2005.

RECLASSIFICATIONS

Certain prior year amounts have been reclassified to conform to the current year presentation.

2. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	DECEMBER 31, 2004	DECEMBER 31, 2005
U.S. trade accounts receivable	$ 3,248,887	$ 2,893,217

Foreign trade accounts receivable	17,148,600	19,619,172
Factored accounts receivable	19,452,756	33,222,354
Other receivables	346,965	1,815,450
Allowance for returns, discounts and bad debts .	(2,437,865)	(2,951,750)
	$ 37,759,343	$ 54,598,443

Under the asset-based lending arrangement we had with GMAC before September 29, 2004, we factored trade receivables from clients with credit ratings below BBB. GMAC did not advance any funds to us and only afforded us a credit insurance coverage. We received funds from GMAC only after such funds were collected from customers at their respective due dates. Effective as of September 29, 2004, the

asset based lending arrangement was amended and converted to a factoring arrangement. At December 31, 2005, substantially all trade receivables, irrespective of their debt ratings, were factored and GMAC advances up to 90% of the invoice value to us immediately upon the submission of invoices. See Note 8 of "Notes to Consolidated Financial Statements."

3. INVENTORY

Inventory consists of the following:

	DECEMBER 31,	
	2004	2005
Raw materials, fabric and trim accessories	$ 1,164,977	$ 5,079,428
Finished goods shipments-in-transit	9,283,022	8,800,014
Finished goods	8,696,106	17,749,518
	$19,144,105	$31,628,960

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	DECEMBER 31,	
	2004	2005
Land	$ 85,000	$ 85,000
Buildings	819,372	819,372
Equipment	5,966,453	6,249,487
Furniture and fixtures	2,228,375	2,308,537
Leasehold improvements	2,605,763	2,684,720
Vehicles	330,564	322,487
	12,035,527	12,469,603
Less accumulated depreciation and amortization .	(10,160,634)	(10,766,763)

	$ 1,874,893	$ 1,702,840
	============	============

Depreciation expense, including amortization of assets recorded under capital leases, totaled $15,663,000, $7,853,000 and $727,000 for the years ended December 31, 2003, 2004 and 2005, respectively.

5. RESTRUCTURING AND SALE OF MEXICO OPERATIONS

Following our restructuring of our Mexican operations in 2003, and the resulting reduction in our Mexican work force, we became the target of workers' rights activists who have picketed our customers, stuffed electronic mailboxes with inaccurate, protest e-mails, and threatened customers with retaliation for continuing business with us. While we have defended our position to our customers, some of our larger customers for Mexico-produced jeans wear have been reluctant to place orders with us in response to actions taken and contemplated by these activist groups. As a consequence, we experienced a significant decline in revenue from sales of Mexico-produced merchandise during 2004. As a result of this reduction in revenue from the sale of Mexico-produced merchandise, the Board of Directors approved a resolution in July 2004 authorizing management to sell the manufacturing operations in Mexico.

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," we evaluated the long-lived assets in Mexico for recoverability and concluded that the book value of the asset group was significantly higher than the expected future cash flows and that impairment had occurred. Accordingly, we recognized a non-cash impairment loss of approximately $78 million in the second quarter of 2004. The impairment charge was the difference between the carrying value and fair value of the impaired assets. Fair value was determined based on independent appraisals of the property and equipment obtained in June 2004. There was no tax benefit recorded with the impairment loss due to a full valuation allowance recorded against the future tax benefit as of June 30, 2004. The entire impairment charge was recorded in the Mexico geographic reporting segment.

In connection with our restructuring of our Mexico operations, we incurred $2.5 million, $1.1 million and $0 of severance costs in 2003, 2004 and 2005, respectively, in the Mexico reportable segment. We did not relocate any employees in connection with this restructuring and therefore did not incur any relocation costs. In addition, we did not incur any contract termination costs. There was no ending liability balance for the severance costs incurred in 2003 and 2004 since such amounts were all paid in 2003 and 2004. Severance costs incurred in 2003 were included in costs of goods sold and such costs incurred in 2004 were included in general and administrative expenses in the accompanying consolidated statements of operations.

In August 2004, through Tarrant Mexico, S. de R.L. de C.V., our majority owned and controlled subsidiary in Mexico, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, which agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico which include equipment and facilities previously leased to Mr. Nacif's affiliates in October 2003, for an aggregate purchase price consisting of the following:

- o $105,400 in cash and $3,910,000 by delivery of unsecured promissory notes bearing interest at 5.5% per annum; and

- $40,204,000, by delivery of secured promissory notes bearing interest at 4.5% per annum, maturing on December 31, 2014, and payable in equal monthly installments of principal and interest over the term of the notes.

Included in the $41.4 million notes receivable - related party on the accompanying balance sheet as of December 31, 2005 was $1,317,000 of Mexico valued added taxes on the real property component of this transaction. The future maturities of the note receivable from the purchasers, including the Mexican value added tax to be paid by the purchasers, is as follows:

YEAR ENDING DECEMBER 31,	AMOUNT
2006	$ 5,139,387
2007	4,866,963
2008	3,835,953
2009	3,898,575
2010	4,077,855
2011 and after	19,589,100
Total	$ 41,407,833

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. This agreement replaced a previously existing purchase commitment agreement whereby we were obligated to purchase annually from Mr. Nacif's affiliates, 6 million yards of fabric (or approximately $19.2 million of fabric at today's market prices) manufactured at these same facilities through October 2009. The annual future purchase commitments approximate the annual maturities of the notes receivable from the related party and are allowed to be offset against annual principal and interest requirements. Included in the current maturities balance is $429,000 related to the 2005 balance due, which we believe is fully collectible and are allowed to be offset against annual principal and interest requirements. We expect to realize the note receivable from related party through the receipt of fabric manufactured at these facilities over the maturity period of the notes receivable.

6. EQUITY METHOD INVESTMENT - AMERICAN RAG

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

the licensor of minimum royalties of $10.4 million over the initial 10-year term of the agreement. Private Brands also entered into a multi-year exclusive distribution agreement with Federated Merchandising Group ("FMG"), the sourcing arm of Federated Department Stores, to supply FMG with American Rag CIE, a new casual sportswear collection for juniors and young men. Private Brands will design and manufacture a full collection of American Rag apparel, which will be distributed by FMG exclusively to Federated stores across the country. Beginning in August 2003, the American Rag collection was available in approximately 100 select Macy's, the Bon Marche, Burdines, Goldsmith's, Lazarus and Rich's-Macy's locations. The investment in American Rag CIE, LLC totaling $1.9 million and $2.1 million at December 31, 2004 and 2005, respectively, 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 for 2005 was as follows:

Balance as of December 31, 2003	$ 1,434,375
Additional capital contribution	137,000
Share of income	769,706
Distribution	(460,800)
Balance as of December 31, 2004	$ 1,880,281
Share of income	559,634
Distribution	(301,050)
Balance as of December 31, 2005	$ 2,138,865

We hold a 45% member interest in American Rag. The remaining 55% owners are an unrelated third party who contributed the American Rag trademark and other assets and liabilities relating to two retail stores operating under the name of "American Rag". The entity is generating positive cash flow and net operating profit from its retail stores. The royalty income paid by us to American Rag is considered other income and is ancillary to the primary operations. Reported revenue from the retail business in fiscal 2004 and 2005 was approximately $9 million and $10 million, respectively. The amount of royalty income paid by us to American Rag in 2003, 2004 and 2005 was $250,000, $500,000 and $575,000, respectively. We do not have sole decision-making ability. Day to day management of American Rag is effectively controlled by one of the 55% owners.

We have not entered into any obligations to guarantee the entity's debt nor do we expect to receive a guaranteed return on its investment. We determined that we are not the primary beneficiary of American Rag and nothing has given rise to a re-evaluation of the investment for consolidation under FIN 46. Our variable interest will not absorb a majority of the VIE's expected losses. We record its proportionate share of income and losses but are not obligated nor do we intend to absorb losses beyond its 45% investment interest. Additionally, we do not expect to receive a majority of the entity's expected residual returns, other than their 45% ownership interest.

The summarized combined financial information for American Rag for the year ended December 31, 2005 was as follows:

BALANCE SHEET	
Current assets	$ 1,889,389
Non-current assets	545,388
TOTAL ASSETS	2,434,777
Current liabilities ...	641,350
Non-current liabilities	83,615
TOTAL LIABILITIES .	$ 724,965
STATEMENT OF INCOME	
Net sales	$10,125,563
Gross profit	5,092,708
Income from operations	585,481
Net income	$ 1,152,431

7. IMPAIRMENT OF ASSETS

IMPAIRMENT OF GOODWILL

Goodwill on the accompanying consolidated balance sheets represents the as "excess of costs over fair value of net assets acquired in previous business combination". SFAS No. 142, "Goodwill and Other Intangible Assets," requires that goodwill and other intangibles be tested for impairment using a two-step process. The first step is to determine the fair value of the reporting unit, which may be calculated using a discounted cash flow methodology, and compare this value to its carrying value. If the fair value exceeds the carrying value, no further work is required and no impairment loss would be recognized. The second step is an allocation of the fair value of the reporting unit to all of the reporting unit's assets and liabilities under a hypothetical purchase price allocation.

In 2003, we ceased directly operating a substantial majority of our equipment and fixed assets in Mexico, and started leasing a large portion of our manufacturing facilities and operations in Mexico to affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, effective September 1, 2003. During 2003, we made an interim review of our goodwill and intangible assets and wrote off all goodwill and intangible assets affected by our strategic changes in Mexico. Write-offs included $9.1 million and $2.7 million directly relating to Tarrant Mexico - Famian and Ajalpan divisions, respectively, and another $7.5 million relating to of Rocky Apparel LLC ("Rocky"). It was unlikely that Tommy Hilfiger, whose business we acquired in the Rocky acquisition, would continue to purchase merchandise from UAV following implementation of the restructuring in Mexico. In 2003, we had also written off the remaining goodwill of $150,000 relating to the acquisition of Jane Doe International, LLC due to litigation with the minority shareholder.

The following table displays the change in the gross carrying amount of goodwill by reporting units for the years ended December 31, 2004 and 2005. The reporting unit below is one level below the reportable segments included in Note 16, "Operations by Geographic Areas". The reporting unit FR TCL. - Chazz & MGI Division was included within the United States geographical segment of Note 16 of the "Notes to the Consolidated Financial Statements."

	REPORTING UNITS FR TCL - CHAZZZ & MGI DIVISION
Balance as of January 1, 2004 .	$8,582,845
Activities for the year	--
Balance as of December 31, 2004	$8,582,845
Activities for the year	--
Balance as of December 31, 2005	$8,582,845

IMPAIRMENT OF OTHER ASSETS

On June 28, 2000, we signed an exclusive production agreement with Manufactures Cheja ("Cheja") through February 2002. We had agreed on a new contract to extend the agreement for an additional quantity of 6.4 million units beginning April 1, 2002, which was amended on November 8, 2002, for the manufacturing of 5.7 million units through September 30, 2004. In June 2003, we determined that we no longer expected to recoup advances to Cheja related to the production agreement.

In June 2003, we wrote off $2.8 million of remaining advances to Cheja.

8. DEBT

Debt consists of the following:

	DECEMBER 31, 2004	DECEMBER 31, 2005
Short-term bank borrowings:		
Import trade bills payable - UPS, DBS Bank and Aurora Capital	$ 3,902,714	$ 4,165,306
Bank direct acceptances - UPS and DBS Bank	10,447,855	1,471,476
Other Hong Kong credit facilities - UPS and DBS Bank	3,600,588	8,196,750
	$ 17,951,157	$ 13,833,532
Long-term debt:		
Vendor financing	$ 135,145	$ --
Equipment financing	78,038	83,206
Term loan - UPS	5,000,000	2,708,333
Debt facility - GMAC	16,960,064	33,558,095
	22,173,247	36,349,634
Less current portion	(19,628,701)	(36,109,699)
	$ 2,544,546	$ 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 may arrange for the issuance of letters of credit and acceptances. The facility is collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by Tarrant Apparel Group and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman, also signed a guarantee of $5 million in favor of UPS to secure this facility. This facility bore interest at 10.25% per annum at December 31, 2005. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. On June 27, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from June 30, 2005 to August 31, 2005 and to reduce the tangible net worth requirement at June 30, 2005. On August 31, 2005, we amended the letter of credit facility with UPS to further extend the expiration date of the facility to October 31, 2005, immediately reduce the maximum amount of borrowings to $14.5 million on September 1, 2005 and further reduced the maximum amount of borrowing to $14.0 million on October 1, 2005. On October 31, 2005, we further amended the letter of credit facility with UPS to extend the expiration date of the facility to January 31, 2006 and amend the interest rate to "prime rate" plus 3%. The facility amendment also provided for reduction in the maximum amount of borrowings to $13.5 million commencing on November 1, 2005, to $13.0 million commencing on December 1, 2005, and to $12.5 million commencing on January 1, 2006. Additionally, Gerard Guez, our Chairman, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. On January 27, 2006, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from January 31, 2006 to July 31, 2006. The amendment provides for reduction of the maximum amount of borrowings under the facility to $12.0 million commencing on April 1, 2006, $11.5 million commencing on May 1, 2006, $11.0 million commencing on June 1, 2006 and to $10.5 million commencing on July 1, 2006. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of $25 million as of December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of $800,000. As of December 31, 2005, we were in compliance with the covenants. As of December 31, 2005, $9.2 million was outstanding under this facility with UPS (classified above as follows: $1.9 million in import trade bills payable; $1.0 million in bank direct acceptances and $6.3 million in other Hong Kong credit facilities) and an additional $2.5 million was available for future borrowings. In addition, $1.3 million of open letters of credit was outstanding as of December 31, 2005.

Since March 2003, DBS Bank (Hong Kong) Limited (formerly known as Dao Heng Bank) has made available a letter of credit facility of up to HKD 20 million (equivalent to US $2.6 million) to our subsidiaries in Hong Kong. This is a demand facility and is secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman, and Todd Kay, our Vice Chairman, and by our guarantee. The letter of credit facility was increased to HKD 30 million

(equivalent to US $3.9 million) in June 2004. As of December 31, 2005, $2.9 million was outstanding under this facility. In addition, $1.1 million of open letters of credit was outstanding and $0 was available for future borrowings as of December 31, 2005. 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. As of December 31, 2005, $675,000 was outstanding under this tax loan.

As of December 31, 2005, the total balance outstanding under the DBS Bank credit facilities was $3.6 million (classified above as follows: $1.3 million in import trade bills payable, $0.5 million in bank direct acceptances and $1.8 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 December 31, 2005, $1.0 million was outstanding under this facility (classified above under import trade bills payable) and $7.1 million of letters of credit were open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

LOAN FROM MAX AZRIA

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

EQUIPMENT FINANCING

We had three equipment loans outstanding at December 31, 2005 totaling $83,000. One of these equipment loans bears interest at 6% payable in installments through 2009, 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.

VENDOR FINANCING

During 2000, we financed equipment purchases for a manufacturing facility with certain vendors. A total of $16.9 million was financed with five-year promissory notes, which bear interest ranging from 7.0% to 7.5%, and were payable in semiannual payments commencing in February 2000. All remaining balances under these notes were paid off in February 2005. A portion of the debt was denominated in Euros. Unrealized transaction (loss) gain associated with the debt denominated in Euros totaled $(561,000), $367,000 and $0 for the years ended December 31, 2003, 2004 and 2005, respectively. These amounts were recorded in other income (expense) in the accompanying consolidated statements of operations.

TERM LOAN - UPS

On December 31, 2004, our Hong Kong subsidiaries entered into a new loan agreement with UPS pursuant to which UPS made a $5 million term loan, the proceeds of which were used to repay $5 million of indebtedness owed to UPS under the letter of credit of facility. The principal amount of this loan is due and payable in 24 equal monthly installments of approximately $208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. This facility bore interest at 9.25% per annum at December 31, 2005. On June 27, 2005, we amended the loan agreement with UPS to reduce the tangible net worth requirement at June 30, 2005. Under the amended loan agreement, we are subject to restrictive financial covenants of maintaining tangible net worth of $25 million at December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditure per quarter at $800,000. As of December 31, 2005, we were in compliance with the covenants. As of December 31, 2005, $2.7 million was outstanding. The obligations under the loan agreement are collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan is secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of $2,550,000 and $1,360,000 and a pledge by Gerard Guez, our Chairman, of 4.6 million shares of our common stock.

DEBT FACILITY AND FACTORING AGREEMENT - GMAC

We were previously party to a revolving credit, factoring and security agreement (the "Debt Facility") with GMAC Commercial Credit, LLC ("GMAC"). This Debt Facility provided a revolving facility of $90 million, including a letter of credit facility not to exceed $20 million, and was scheduled to mature on January 31, 2005. The Debt Facility also provided a term loan of $25 million, which was being repaid in monthly installments of $687,500. The Debt Facility provided for interest at LIBOR plus the LIBOR rate margin determined by the Total Leverage Ratio (as defined in the Debt Facility agreements), and was collateralized by our receivables, intangibles, inventory and various other specified non-equipment assets. In May 2004, the maximum facility amount was reduced to $45 million in total and we established new financial covenants with GMAC for the fiscal year of 2004.

On October 1, 2004, we amended and restated the Debt Facility with GMAC by entering into a new factoring agreement with GMAC. The amended and restated agreement (the factoring agreement) extended the expiration date of the facility to September 30, 2007 and added as parties our subsidiaries Private Brands, Inc and No! Jeans, Inc. In addition, in connection with the factoring agreement, our indirect majority-owned subsidiary PBG7, LLC entered into a separate factoring agreement with GMAC. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC, as factor, all accounts which arise from our sale of merchandise or rendition of service created on a going forward basis. At our request, GMAC, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC has the risk of loss and (b) $40 million, minus in each case, any amount owed by us to GMAC. Pursuant to the terms of the PBG7 factoring agreement, PBG7 agreed to assign and sell to GMAC, as factor, all accounts, which arise from PBG7's sale of merchandise or rendition of services created on a going-forward basis. At PBG7's request, GMAC, in its discretion, may make advances to PBG7 up to the lesser of (a) up to 90% of PBG7's accounts on which GMAC has the risk of loss, and (b) $5 million minus in each case, any amounts owed to GMAC by PBG7. The facility bears interest at 7.385% per annum and the facility under PBG7, LLC bears interest at 7.75% per annum at December 31, 2005. Restrictive covenants under the revised facility include a limit on quarterly capital expenses of $800,000 and tangible net worth of $25 million at December 31, 2005 and at the end of each fiscal quarter thereafter. As of December 31, 2005, we were in compliance with the covenants. A total of $30.6 million was outstanding with respect to receivables factored under the GMAC facility at December 31, 2005.

In May 2005, we amended our factoring agreement with GMAC to permit our subsidiaries party thereto and us, to borrow up to the lesser of $3 million or fifty percent (50%) of the value of eligible inventory. In connection with this amendment, we granted GMAC a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC 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 will be reduced to $4 million on April 1, 2006 and will be further reduced to $3 million on July 1, 2006. The maximum borrowing availability under the factoring agreement, based on the borrowing base formula remains at $40 million. A total of $3.0 million was outstanding under the GMAC facility at December 31, 2005 with respect to collateralized inventory.

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

Annual maturities for the long-term debt, convertible debentures and capital lease obligations are $36.1 million (2006), $7.1 million (2007), $14,000 (2008), and $5,000 (2009). The effective interest rate on short-term bank borrowing as of December 31, 2003, 2004 and 2005 were 5.3%, 5.7% and 7.8%, respectively.

GUARANTEES

Guarantees had been issued since 2001 in favor of YKK, Universal Fasteners, and RVL Inc. for $750,000, $500,000 and unspecified amount, respectively, to cover trim purchased by Tag-It Pacific Inc. on our behalf. We have not reported a liability for these guarantees. We issued the guarantees to cover trim purchased by Tag-It in order to ensure our production in a timely manner. If Tag-It ever defaults, we would have to pay the outstanding liability due to these vendors by Tag-It for purchases made on our behalf. We have not had to perform under these guarantees since inception. It is not predictable to estimate the fair value of the guarantee; however, we do not anticipate that we will incur losses as a result of these guarantees. In April 2005, we terminated these guarantees with respect to Tag-It's obligations arising after the date of termination.

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 convertible debenture was thus valued at $8,996,000, resulting in an effective conversion price of $1.799 per share. The intrinsic value of the conversion option of $804,000 is being amortized over the life of the loan. The value of the warrants of $866,000 and the intrinsic value of the conversion option of $804,000 were netted from the $10 million presented as the convertible debentures, net on our accompanying balance sheets at December 31, 2004.

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

In June 2005, holders of our Debentures converted an aggregate of $2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of $820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of $2.00 per share. Debt discount of $248,000 related to the intrinsic value of the conversion option of $804,000 was expensed upon the conversion. Of the $620,000 financing cost paid to the placement agent, $191,000 was expensed upon the conversion. The intrinsic value of the conversion option, and the value of the warrant amortized in 2005 was $474,000. Total deferred financing cost amortized in 2005 was $189,000. Total interest paid to the holders of the Debentures in 2005 was $539,000. As of December 31, 2005, $6.0 million, net of $0.9 million of debt discount, remained outstanding under the Debentures.

10. INCOME TAXES

The provision (credit) for domestic and foreign income taxes is as follows:

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Current:			
Federal	$ 2,400,000	$ 1,000,000	$ --
State	(241,948)	8,511	2,425
Foreign	2,106,199	1,400,953	1,091,442
	4,264,251	2,409,464	1,093,867
Deferred:			
Federal	--	--	--
State	--	--	--
Foreign	(132,622)	(61,345)	(166,686)
	(132,622)	(61,345)	(166,686)
Total	$ 4,131,629	$ 2,348,119	$ 927,181

The source of loss before the provision for taxes and cumulative effect of accounting change is as follows:

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Federal	$ (18,609,818)	$ (14,271,441)	$ (4,481,879)
Foreign	(13,143,213)	(88,057,111)	6,402,404
Total	$ (31,753,031)	$(102,328,552)	$ 1,920,525

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, it is 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.

A reconciliation of the statutory federal income tax provision (benefit) to the reported tax provision (benefit) on income is as follows:

YEAR ENDED DECEMBER 31,

	2003	2004	2005
Income tax (benefit) based on federal statutory rate	$(11,113,561)	$(35,814,993)	$ 672,184
State income taxes, net of federal benefit	(157,266)	5,532	(246,978)
Effect of foreign income taxes	2,862,550	2,749,376	(1,316,085)
Nondeductible goodwill impairment	4,141,426	--	--
Nondeductible impairment of long-lived assets	--	30,463,663	--
Increase in tax reserve	2,400,000	1,000,000	--
Increase in valuation allowance and other	5,998,480	3,944,541	1,818,060
	$ 4,131,629	$ 2,348,119	$ 927,181

Deferred income taxes reflect the net effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the deferred tax assets (liabilities) are as follows:

	DECEMBER 31,	
	2004	2005
Deferred tax assets:		
Provision for doubtful accounts and unissued credits	$ 433,261	$ 117,979
Provision for other reserves	1,533,620	2,874,377
Domestic and foreign loss carry forwards and foreign tax credits	9,789,485	11,162,380
Goodwill impairment	2,719,294	2,138,984
Total deferred tax assets	14,475,660	16,293,720
Deferred tax liabilities:		
Other	(213,784)	(47,098)
	(213,784)	(47,098)
Valuation allowance for deferred tax assets	(14,475,660)	(16,293,720)
Net deferred tax liabilities	$ (213,784)	$ (47,098)

At December 31, 2005, we have $32.1 million of federal net operating loss carryforwards expiring in 2024. We also have foreign tax credits carryforwards totaling $833,000 that do not expire.

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

11. COMMITMENTS AND CONTINGENCIES

We have entered into various non-cancelable operating lease agreements, principally for executive office, warehousing facilities and production facilities with unexpired terms in excess of one year. Certain of these leases provided for scheduled rent increases. We record rent expense on a straight-line basis over the term of the lease. The future minimum lease payments under these non-cancelable operating leases are as follows:

2006	$ 1,188,000
2007	710,000
2008	585,000
2009	600,000
2010	627,000
Thereafter	3,128,000
Total future minimum lease payments	$ 6,838,000

Included in the future minimum lease payments, $420,000 payable to Lynx International Limited, a Hong Kong corporation that is owned by Messrs. Guez and Kay for leasing our warehouse and office space in Hong Kong. See Note 15 of the "Notes to Consolidated Financial Statements."

Several of the operating leases contain provisions for additional rent based upon increases in the operating costs, as defined, per the agreement. Total rent expense under the operating leases amounted to approximately $3,101,000, $2,128,000 and $1,295,000 for 2003, 2004 and 2005, respectively.

We entered into a new lease agreement in June 2005 in New York as our showroom through June 2015. This is currently the location used for the private brands sales, design and technical departments, which functions we moved from our Los Angeles executive office.

We had open letters of credit of $5,976,000, $9,987,000 and $9,519,000 as of

December 31, 2003, 2004 and 2005, respectively.

We have two employment contracts dated January 1, 1998, and subsequently amended, with two executives providing for base compensation and other incentives. On April 1, 2004, we amended each of these contracts to extend the term through March 31, 2006, and to provide one contract for base salary per annum of $500,000 for the period from April 1, 2003 to March 31, 2006, and the other contract for base salary per annum of $50,000 from April 1, 2003 to March 31, 2006. Additionally, we agreed to pay each of these executives an annual bonus (the "Annual Bonus") for fiscal years ended December 31, 2003, 2004 and 2005 in an amount, if any, equal to ten percent (10%) of the amount by which our actual pre-tax income for such fiscal year exceeds the amount of projected pre-tax income set forth in our annual budget for the same fiscal year as approved by our Board of Directors. No bonuses were paid to these executives for the fiscal year ended December 31, 2003, 2004 and 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 in missy, juniors and large sizes. This agreement has an initial three-year term, and provided we are in compliance with the terms of the agreement, is renewable for one additional two-year term. Minimum net sales are $20 million in year 1, $25 million in year 2 and $30 million in year 3. The agreement provides for payment of a sales royalty and advertising commitment at the rate of 8% and 3%, respectively, of net sales, for a total minimum payment obligation of $8.3 million over the initial term of the agreement. On July 19, 2005, Camuto Consulting Group replaced J.S. Brand Management as the master licensor. 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. As of December 31, 2005, we had an outstanding advance of $1.1 million. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands.

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 is a three-year contract, and providing compliance with all terms of the license, is renewable for one additional three-year term. Minimum net sales are $10 million in year 1, $20 million in year 2 and $30 million in year 3. The agreement also provides payment of royalty 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 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 agreement and recognized a loss accordingly in 2005. The loss was classified as royalty expense on our consolidated statements of operations.

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. At December 31, 2005, the total commitment on royalties remaining on the term was $9.1 million.

On October 16, 2003, we entered into a lease with affiliates of Mr. Kamel Nacif, a substantial portion of our manufacturing facilities and operations in Mexico including real estate and equipment. The lease was effective as of September 1, 2003. We leased our twill mill in Tlaxcala, Mexico, and our sewing plant in Ajalpan, Mexico, for a period of 6 years and for an annual rental fee of $11 million. Mr. Nacif was a stockholder at the time of transaction. In connection with this transaction, we also entered into a management services agreement pursuant to which Mr. Nacif's affiliates managed the operation of our remaining facilities in Mexico in exchange for use of the remaining facilities. The term of the management services agreement was also for a period of 6 years. Additionally, we agreed to purchase annually, six million yards of fabric manufactured at the facilities leased and/or operated by Mr. Nacif's affiliates at market prices to be negotiated. See Note 15 of the "Notes to Consolidated Financial Statements." Using current market prices, the purchase commitment would be approximately $18 million per year.

In connection with the restructuring of our Mexican operations, and the resulting reduction in our Mexican work force, we became the target of workers' rights activists who have picketed our customers, stuffed electronic mailboxes with inaccurate, protest e-mails, and threatened customers with retaliation for continuing business with us. While we have defended our position to our customers, some of our larger customers for Mexico-produced jeans wear have been reluctant to place orders with us in response to actions taken and contemplated by these activist groups. As a consequence of these actions, we experienced a significant decline in revenue of approximately $75 million from sales of Mexico-produced merchandise in 2004 as compared to 2003.

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. This agreement replaced an existing purchase commitment agreement with Mr. Nacif's affiliates. In August 2004, upon entering into an Agreement for Purchase of Assets, Mr. Nacif's affiliates agreed to suspend our fabric purchase obligations under the existing purchase commitment, and we agreed to suspend the affiliates of Mr. Nacif's lease payment obligations under the lease agreements pursuant to which Mr. Nacif's affiliates operated our manufacturing facilities in Mexico. See Note 15 of the "Notes to Consolidated Financial Statements."

We are involved from time to time in routine legal matters incidental to our business. In our opinion, resolution of such matters will not have a material effect on our financial position or results of operations.

12. EQUITY

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

Our Employee Incentive Plan, formerly the 1995 Stock Option Plan, as amended and restated in May 1999 (the Plan), has authorized the grant of both incentive and non-qualified stock options to officers, employees, directors and consultants of the Company for up to 5,100,000 shares (as adjusted for a stock split effective May 1998) of our common stock. The exercise price of incentive options must be equal to 100% of fair market value of common stock on the date of grant and the exercise price of non-qualified options must not be less than the par value of a share of common stock on the date of grant. The Plan was also amended to expand the types of awards, which may be granted pursuant thereto to include stock appreciation rights, restricted stock and other performance-based benefits. At December 31, 2005, no further options may be granted under the Plan.

In October 1998, we granted 1,000,000 non-qualified stock options not under 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. The options expire in 2008 and vest over four years. In May 2002, we granted 3,000,000 non-qualified stock options not under the Plan. The 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. The options expire in 2012 and vest 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 not under the Plan to our Chairman and Vice Chairman. The options were granted at $3.65 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2013 and vest over four years. In December 2003, we granted 400,000 non-qualified stock options not under the Plan to our President. The options were granted at $3.94 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2013 and vest over four years.

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

A summary of our stock option activity, and related information is as follows:

	2003		2004		2005
	OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS
Options outstanding at beginning of year	6,376,487	$ 8.89	8,926,087	$ 7.13	8,331,962
Granted	3,288,100	3.67	83,000	3.04	42,000
Exercised	--	--	--	--	--
Forfeited	(738,500)	6.91	(677,125)	5.43	(1,573,300)
Expired	--	--	--	--	(67,612)
Outstanding at end of year	8,926,087	$ 7.13	8,331,962	$ 7.22	6,733,050
Exercisable at end of year	4,028,487	$10.56	5,251,250	$ 9.04	6,733,050
Weighted average per option fair value of options granted during the year		$ 1.92		$ 1.36	

The following table summarizes information about stock options outstanding at December 31, 2005:

	OPTIONS OUTSTANDING			OPTIONS EXERCIS
EXERCISE PRICE	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE
$ 1.39 - $ 2.84	56,000	8.1	$ 2.41	56,000
$ 3.60 - $ 3.68	2,388,050	7.5	3.64	2,388,050
$ 3.94 - $ 5.09	763,000	7.2	4.30	763,000
$ 5.50	2,004,000	6.3	5.50	2,004,000
$ 5.55 - $ 9.97	444,500	2.4	7.05	444,500
$13.50 - $15.50	1,011,000	2.7	13.51	1,011,000
$18.44 - $18.50	23,000	2.7	18.50	23,000
$33.13 - $39.97	41,500	3.1	39.31	41,500
$45.50	2,000	3.2	45.50	2,000
$ 1.39 - $45.50	6,733,050	6.0	$ 6.25	6,733,050

13. EQUITY TRANSACTIONS

In October 2003, we sold an aggregate of 881,732 shares of the Series A Convertible Preferred Stock, at $38 per share, to a group of institutional investors and high net worth individuals and raised an aggregate of approximately $31 million, after payment of commissions and expenses. We used the proceeds of this offering to pay down vendors and reduce debts. The preferred stock was converted into an aggregate of 8,817,320 shares of common stock following a special meeting of shareholders held on December 4, 2003 in accordance with the original conversion terms. We have registered the shares of common stock issued upon conversion of the Series A Preferred Stock with the Securities and Exchange Commission for resale by the investors. In conjunction with the private placement transaction, we issued a warrant to purchase 881,732 shares of common stock to the placement agent. The warrants are exercisable beginning April 17, 2004 through October 17, 2008 and have a per share exercise price of $4.65. Warrants were valued 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 0.51; and an expected life of four years.

As previously disclosed, following a review of the accounting treatment of our October 2003 private placement of convertible preferred stock, we revised our accounting treatment for this transaction to record a beneficial conversion feature in accordance with Emerging Issues Task Force ("EITF") No. 98-5 and to restate our financial statements for the fiscal years ended December 31, 2003 and 2004 to reflect the beneficial conversion feature of the convertible preferred stock. We restated our 2003 and 2004 financial statements to reflect the recording of the beneficial conversion feature of approximately $7.5 million in the fourth quarter of 2003 relating to the issuance of 881,732 shares of Series A convertible preferred stock. The beneficial conversion feature of the preferred shares in the amount of $7.5 million was recorded in the fourth quarter of 2003, resulting in an increase in loss per share to common shareholders for the year ended December 31, 2003 to $(2.38) per share from the previously reported $(1.97) per share. The beneficial conversion feature did not change our reported earnings (loss) per share for the year ended December 31, 2004. The effect of recording the beneficial conversion feature on the December 31, 2004 financial statements was an increase in the accumulated deficit of $7.5 million and an offsetting increase in contributed capital. The restatement did not change total shareholders' equity at December 31, 2003 or 2004.

In November 2003, we issued an aggregate of 200,000 shares of common stock to Antonio Haddad Haddad, Miguel Angel Haddad Yunes, Mario Alberto Haddad Yunes, and Marco Antonio Haddad Yunes in partial settlement of the balance of approximately $2.5 million in obligations owed these parties arising from our acquisition of their factories in 1998. The fair value of the common stock issued on the date of issuance was $3.94 per share, resulting in a reduction of our obligation by $788,000.

During the year of 2003, we retired a total of 248,872 shares of common stock relating to shares repurchased but uncancelled before 2001 and shares repurchased in 2003 from Gabe Zeitouni, upon exercising his put option under an agreement dated July 10, 2000.

In January 2004, we sold an aggregate of 1,200,000 shares of our common stock at a price of $3.35 per share, for aggregate proceeds to us of approximately $3.7 million after payment of placement agent fees and other offering expenses. We used the proceeds of this offering for working capital purposes. The securities sold in the offering were registered under the Securities Act of 1933, as amended, pursuant to our effective shelf registration statement. In conjunction with this public offering, we issued a warrant to purchase 30,000 shares of our common stock to the placement agent. This warrant has an exercise price of $3.35 per share, is fully vested and exercisable and has a term of five years. The warrant was valued using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 3%; dividend yields of 0%; volatility factors of the expected market price of warrants of 0.51; and an expected life of four years.

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 June 2005, holders of our Debentures converted an aggregate of $2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of $820,000 of Debentures into 410,000 shares of our common stock. See Note 9 of the "Notes to Consolidated Financial Statements."

In November 2003, our board of directors adopted a shareholders rights plan. Pursuant to the plan, we issued a dividend of one right for each share of our common stock held by shareholders of record as of the close of business on December 12, 2003. Each right initially entitled shareholders to purchase a fractional share of our Series B Preferred Stock for $25.00. However, the rights are not immediately exercisable and will become exercisable only upon the occurrence of certain events. Generally, if a person or group acquires, or announces a tender or exchange offer that would result in the acquisition of 15% or more of our common stock while the shareholder rights plan remains in place, then, unless the rights are redeemed by us for $0.001 per right, the rights will become exercisable, by all rights holders other than the acquiring person or group, for our shares or shares of the third party acquirer having a value of twice the right's then-current exercise price. The shareholder rights plan is designed to guard against partial tender offers and other coercive tactics to gain control of our company without offering a fair and adequate price and terms to all of our shareholders. The plan was not adopted in response to any efforts to acquire our company, and we are not aware of any such efforts.

Our credit agreement prohibits the payment of dividends during the term of the agreement.

14. SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Cash paid for interest	$2,856,000	$1,796,000	$3,335,000
Cash paid for income taxes	$ 378,000	$1,196,000	$ 875,000

In 1999, we acquired Industrial Exportadora Famian from the Haddad family. In accordance with the acquisition agreement, we had to pay certain amount of earnouts to the vendors annually. As of October 31, 2003, total earnouts accrued but not paid amounted to about $2.5 million. In November 2003, we entered into an agreement with the Haddad family to satisfy the amount owed by issuing to four family members a total of 200,000 shares of common stock, with a fair value of $788,000. In addition, we gave them 400,000 yards of our stock fabric, 100,000 pairs of pants, and a fleet of old vehicles, with an aggregate book value of approximately $1.5 million. Included in other income was a gain of $236,000 resulting from this settlement in 2003.

In 2003, we reduced a shareholder receivable for $722,000 from Mr. Kamel Nacif against vendor payables owed to entities controlled by Mr. Nacif.

In 2004, as consideration for the sale of our assets and real property in Mexico, we received $45.4 million of notes receivable. See Note 5 of "Notes to Consolidated Financial Statements."

On December 14, 2004, we completed a $10 million financing through the issuance of 6% Secured Convertible Debentures ("Debentures"), we issued warrants to purchase up to 1,250,000 shares of our common stock. The warrants were valued at $866,000 using the Black-Scholes option valuation model. The placement agent in the financing, for its services were paid $620,000 in cash and issued five year warrants to purchase up to 200,000 shares of our common stock at an exercise price of $2.50 per share. The 200,000 warrants were valued at $138,000 using the Black-Scholes option valuation model.

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 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.

In 2005, we purchased $6.4 million of fabric from Acabados y Terminados, of which $2.4 million was paid in cash and $4.0 million was offset against the notes receivable principal and accrued interest on the note receivable from the affiliates of Mr. Kamel Nacif.

15. RELATED-PARTY TRANSACTIONS

Related-party transactions, consisting primarily of purchases and sales of finished goods and raw materials, are as follows:

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Sales to related parties	$22,296,000	$ 3,598,000	$ 88,000
Purchases from related parties	$72,329,000	$17,875,000	$ 6,987,000

As of December 31, 2004 and 2005, related party affiliates were indebted to us in the amounts of $13.1 million and $8.4 million, respectively. These include amounts due from Gerard Guez, our Chairman of $2.5 million and $2.3 million at December 31, 2004 and 2005, respectively, which have been shown as reductions to shareholders' equity in the accompanying financial statements. Total interest paid by Mr. Guez was $374,000, $370,000 and $209,000 for the years ended December 31, 2003, 2004 and 2005, respectively.

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 during 2005 was approximately $4,766,000. At December 31, 2005, the entire balance due from Mr. Guez totaling $2.3 million was reflected as a reduction of shareholders' equity. All advances to, and borrowings from, Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was $374,000, $370,000 and $209,000 for the years ended December 31, 2003, 2004 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately $400,000 and $397,000 for the years ended December 31, 2004 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 officers or directors of Tarrant.

In February 2004, our Hong Kong subsidiary entered into a 50/50 joint venture with Auto Enterprises Limited, an unrelated third party, to source products for Seven Licensing Company, LLC and our private brands subsidiary in mainland China. On May 31, 2004, after realizing an accumulated loss from the venture of approximately $200,000 (our share being half), we sold our interest for $1 to Asia Trading Limited, a company owned by Jacqueline Rose, wife of Gerard Guez. The venture owed us $221,000 as of December 31, 2004. This amount was repaid in the first quarter of 2005.

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

Since June 2003, United Apparel Venture, LLC had been selling to Seven Licensing Company, LLC ("Seven Licensing"), jeans wear bearing the brand "Seven7", which is ultimately purchased by Express. Seven Licensing is beneficially owned by Gerard Guez. In the third quarter of 2004, in order to strengthen our own private brand business, we decided to discontinue sourcing for Seven7. Total sales to Seven Licensing during the years ended December 31, 2003, 2004 and 2005 were $8.1 million, $2.6 million and $0, respectively. In 1998, a California limited liability company owned by our Chairman and Vice Chairman purchased 2,300,000 shares of the common stock of Tag-It Pacific, Inc. ("Tag-It") (or approximately 37% of such common stock then outstanding). Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Starting from 1998, Tag-It assumed the responsibility for managing and sourcing all trim and packaging used in connection with products manufactured by or on behalf of us in Mexico. We believe that the terms of this arrangement, which is subject to the acceptance of our customers, are no less favorable to us than could be obtained from unaffiliated third parties. Due to the restructuring of our Mexico operations, Tag-It no longer manages our trim and packaging requirements. We purchased $16.8 million, $1.0 million and $450,000 of trim inventory from Tag-It for the years ended December 31, 2003, 2004 and 2005, respectively. We also sold to Tag-It $1.5 million from our trim and fabric inventory for the year ended December 31, 2003. We purchased $37.1 million, $11.5 million and $135,000 of finished goods and service from Azteca and its affiliates for the years ended December 31, 2003, 2004 and 2005, respectively. Azteca is owned by the brothers of our Chairman, Gerard Guez, and is the minority member of our subsidiary, United Apparel Ventures, LLC. Our total sales of fabric and service to Azteca in 2003, 2004 and 2005 were $9.9 million, $1.0 million and $88,000, respectively. Two and one half percent of gross sales as management fees were paid in 2003, 2004 and 2005 to each of the members of UAV, per the operating agreement. The amount paid to Azteca, the minority member of UAV, totaled $1.7 million, $179,000 and $0 in 2003, 2004 and 2005, respectively. Net amounts due from these related parties as of December 31, 2004 and 2005 were $7.8 million and $5.5 million, respectively.

On October 16, 2003, we entered into a lease with affiliates of Mr. Kamel Nacif, a substantial portion of our manufacturing facilities and operations in Mexico including real estate and equipment. The lease was effective as of September 1, 2003. We leased our twill mill in Tlaxcala, Mexico, and our sewing plant in Ajalpan, Mexico, for a period of 6 years and for an annual rental fee of $11 million. Mr. Nacif was a shareholder at the time of the transaction. In connection with this transaction, we also entered into a management services agreement pursuant to which Mr. Nacif's affiliates managed the operation of our remaining facilities in Mexico. The term of the management services agreement was also for a period of 6 years. Additionally, we entered into a purchase commitment agreement with Mr. Nacif's affiliates to purchase annually, six million yards of fabric manufactured at the facilities leased and/or operated by Mr. Nacif's affiliates at market prices to be negotiated. See Note 11 "Commitments and Contingencies," of the "Notes to Consolidated Financial Statements." Using current market prices, the purchase commitment would be approximately $18 million per year. We agreed to pay $1 for each yard of fabric that we fail to purchase under the agreement. We purchased $3.6 million and $5.3 million of fabric from Acabados y Terminados under this agreement in 2003 and 2004, respectively.

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. This agreement replaced a previously existing purchase commitment agreement with Mr. Nacif's affiliates. We purchased $6.4 million of fabric, of which $2.4 million was paid in cash and $4.0 million was offset against the notes receivable principal and accrued interest on the note receivable from the affiliates of Mr. Kamel Nacif in 2005. Net amount due from these related parties as of December 31, 2005 was $236,000.

We lease our executive offices in Los Angeles, California from GET, a corporation which is owned by Gerard Guez and Todd Kay, our Chairman and Vice Chairman, respectively. 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 $1,330,000 in rent annually in each of 2003 and 2004 and $1,019,000 in 2005 for office and warehouse facilities. Our Los Angeles offices and warehouse is leased on a month to month basis. On January 1, 2006, we entered into a one year lease agreement with Lynx International Limited for our office space in Hong Kong.

We reimbursed Mr. Guez, our Chairman, for 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.

At December 31, 2004 and 2005, we had various employees receivable totaling $403,000 and $370,000, respectively, included in due from related parties.

We entered into lease agreements with the former owners of Industrial Exportadora Famian and our former employees. Under theses leases, we paid $943,000 in 2003, for rent for sewing and washing facilities in Tehuacan, Mexico. All these lease agreements were cancelled in November 2003.

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. The investment in American Rag Cie, LLC totaling $2.1 million at December 31, 2005 was accounted for under the equity method and included in equity method of investment on the accompanying consolidated balance sheets.

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

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	ASIA	MEXICO	LUXEMBOURG
2003				
Sales......................	$ 291,993,000	$ 7,359,000	$ 21,071,000	$ --
Inter-company sales........	33,441,000	112,481,000	75,716,000	--

Total revenue.............	$ 325,434,000	$ 119,840,000	$ 96,787,000	$ --
Income (loss) from operations	$(11,078,000)	$ 7,556,000	$ (30,116,000)	$ --
Interest income...........	$ 419,000	$ 725,000	$ 6,000	$ --
Interest expense..........	$ 5,215,000	$ 41,000	$ 347,000	$ 725,000
Provision for depreciation and amortization.........	$ 1,547,000	$ 261,000	$ 14,290,000	$ --
Capital expenditures.......	$ 94,000	$ 84,000	$ 190,000	$ --
Total assets..............	$ 128,058,000	$ 117,783,000	$ 201,050,000	$ 213,051,000
2004				
Sales.....................	$ 149,568,000	$ 1,838,000	$ 4,047,000	$ --
Inter-company sales........	--	80,420,000	7,453,000	--
Total revenue.............	$ 149,568,000	$ 82,258,000	$ 11,500,000	$ --
Income (loss) from operations	$ (13,231,000)	$ 3,663,000	$ (89,400,000)	$ (33,000)
Interest income...........	$ 378,000	$ 856,000	$ --	$ --
Interest expense..........	$ 2,766,000	$ 55,000	$ 38,000	$ 854,000
Provision for depreciation and amortization.........	$ 1,283,000	$ 219,000	$ 6,836,000	$ --
Capital expenditures.......	$ 48,000	$ 64,000	$ --	$ --
Total assets..............	$ 113,046,000	$ 121,007,000	$ 31,603,000	$ 212,165,000
2005				
Sales.....................	$ 213,205,000	$ 1,282,000	$ 161,000	$ --
Inter-company sales........	--	135,531,000	--	--
Total revenue.............	$ 213,205,000	$ 136,813,000	$ 161,000	$ --
Income (loss) from operations	$ (928,000)	$ 5,071,000	$ (470,000)	$ (48,000)
Interest income...........	$ 223,000	$ 1,955,000	$ --	$ 1,856,000
Interest expense..........	$ 4,219,000	$ 403,000	$ 2,000	$ 1,954,000
Provision for depreciation and amortization.........	$ 2,025,000	$ 102,000	$ --	$ --
Capital expenditures.......	$ 335,000	$ 224,000	$ --	$ --

Total assets..............	$ 115,327,000	$ 129,737,000	$ 15,782,000	$ 212,019,000

17. EMPLOYEE BENEFIT PLANS

On August 1, 1992, Tarrant Hong Kong established a defined contribution retirement plan covering all of its Hong Kong employees whose period of service exceeds 12 months. Plan assets are monitored by a third-party investment manager and are segregated from those of Tarrant Hong Kong. Participants may contribute up to 5% of their salary to the plan. We make annual matching contributions. Costs of the plan charged to operations for 2003, 2004 and 2005 amounted to approximately $157,000, $131,000 and $160,000, respectively.

On July 1, 1994, we established a defined contribution retirement plan covering all of our U.S. employees whose period of service exceeds 12 months. Plan assets are monitored by a third-party investment manager and are segregated from those of ours. Participants may contribute from 1% to 15% of their pre-tax compensation up to effective limitations specified by the Internal Revenue Service. Our contributions to the plan are based on a 50% (100% effective July 1, 1995) matching of participants' contributions, not to exceed 6% (5% effective July 1, 1995) of the participants' annual compensation. In addition, we may also make a discretionary annual contribution to the plan. Costs of the plan charged to operations for 2003, 2004 and 2005 amounted to approximately $256,000, $226,000 and $199,000, respectively.

On December 27, 1995, we established a deferred compensation plan for executive officers. Participants may contribute a specific portion of their salary to such plan. We do not contribute to the Plan.

18. OTHER INCOME AND EXPENSE

Other income and expense consists of the following:

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Rental income	$3,957,365	$5,854,698	$ 193,127
Gain on sale of fixed assets	--	--	124,041
Unrealized gain on foreign currency	--	367,262	--
Realized gain on foreign currency	304,060	--	--
Gain on legal settlement	235,785	--	--
Other items	287,269	144,677	37,179
Total other income	$4,784,479	$6,366,637	$ 354,347
Unrealized loss on foreign currency	560,602	--	--
Realized loss on foreign currency	--	511,586	--
Loss on sale of fixed assets	593,626	--	--
Other items	28,692	17,671	580
Total other expense	$1,182,920	$ 529,257	$ 580

19. LEGAL PROCEEDINGS

1. PATRICK BENSIMON

On April 12, 2000, we formed a company, Jane Doe International, LLC ("JDI") for the sole purpose of purchasing the assets of Needletex, Inc., owner of the Jane Doe brand. JDI was owned 51% by Fashion Resource (TCL), Inc., our subsidiary, and 49% by Needletex, Inc. In connection with the establishment of JDI, JDI entered into an employment agreement with Patrick Bensimon, the principal shareholder of Needletex, Inc., which provided for the payment of a salary to Patrick Bensimon and a bonus tied to the new company's sales performance. Thereafter a dispute arose as to whether Patrick Bensimon had performed in accordance with his terms of employment set forth in the Employment Agreement. When an amicable resolution of this dispute could not be achieved, Patrick Bensimon commenced an arbitration preceding against his employer, JDI, Fashion Resource (TCL), Inc., the managing member of Jane Doe International and us. On April 7, 2003, the arbitration panel issued a final award in favor of Patrick

Bensimon of $1,425,655 for salary and bonus, plus interest accrued and his costs and attorneys fees in the amount of $489,640. In January 2004, we settled the employment litigation with Patrick Bensimon for $1.2 million in cash and forgiveness of approximately $859,000 in debts owed by Needletex Inc. As part of the settlement, we received the remaining 49% interest in JDI. We also settled with our insurance carrier for a cash payment of $330,000. An additional expense of approximately $379,000 was made in the fourth quarter of 2003 to cover the forgiveness of debts.

2. NICOLAS NUNEZ

In March 2005, we reached a settlement of a dispute involving a former employee named Nicolas Nunez. Mr. Nunez was employed by us pursuant to a written employment agreement until he was terminated in or about November 2000. In connection to this employment, we agreed to acquire Nunez' company by merger. Mr. Nunez claimed to be entitled to shares of our common stock up to a value of $500,000 assuming we did not otherwise have valid defenses to such claims. In connection with the settlement, we agreed to compensate Mr. Nunez in the total amount of $875,000. The full amount of $875,000 had been accrued and included in accrued liabilities in the accompanying balance sheet at December 31, 2004. All parties to both proceedings have agreed to exchange full mutual releases of any and all claims, known or unknown, and will dismiss both proceedings with prejudice, without admitting any liability.

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.

3. MR. BENJAMIN DOMINGUEZ GONZALEZ

On December 10, 2004 and December 14, 2004, Mr. Benjamin Dominguez Gonzalez brought suits against our Mexico Subsidiary, Tarrant Mexico, S. de R.L. de C.V., in Puebla, Puebla, Mexico: (a) "Juicio Ejecutivo Mercantil 887/2004, Juzgado Dicimo de lo Civil del Estado de Puebla, Puebla, Mexico, Dominguez Gonzalez Benjamin vs. Tarrant Mexico S. de R.L. de C.V. e Inmobiliaria Cuadros S.A. de C.V."; and (b) "Juicio Ejecutivo Mercantil 889/2004, Juzgado Noveno de lo Civil del Estado de Puebla, Puebla, Mexico, Dominguez Gonzalez Benjamin vs. Tarrant

Mexico S. de R.L. de C.V. e Inmobiliaria Cuadros S.A. de C.V.", for the non-payment of approximately $14 million in principal amount and accrued interest on two promissory notes, which Mr. Gonzalez asserts were issued by Tarrant Mexico. The amounts Mr. Gonzalez claimed were due and owing under the notes previously had been paid in full. In April 2005, Mr. Gonzalez agreed to dismiss his claims, which agreement has been approved by the court.

4. BAZAK INTERNATIONAL CORPORATION

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 December 18, 2006. We will continue to vigorously defend against the breach of contract and unjust enrichment claim.

20. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

	QUARTER ENDED			
	MAR. 31	JUN. 30	SEP. 30	DEC. 31
	(In thousands, except per share data)			
2004				
Net sales	$ 42,155	$ 38,489	$ 38,102	$ 36,707
Gross profit	7,500	5,266	4,135	4,060
Operating loss	(5,963)	(84,585)	(3,626)	(27,613)
Net loss	$ (2,974)	$(68,567)	$ (4,019)	$(29,117)
Net loss per common share:				
Basic	$ (0.10)	$ (2.39)	$ (0.14)	$ (1.01)
Diluted	$ (0.10)	$ (2.39)	$ (0.14)	$ (1.01)
Weighted average shares outstanding:				
Basic	28,485	28,649	28,815	28,815
Diluted	28,485	28,649	28,815	28,815
2005				
Net sales	$ 44,830	$ 50,538	$ 69,566	$ 49,714
Gross profit	8,946	11,454	14,545	9,936
Operating income	233	1,437	3,011	(1,056)
Net income (loss)	$ (106)	$ 871	$ 1,702	$ (1,474)
Net loss per common share:				
Basic	$ (0.00)	$ 0.03	$ 0.05	$ (0.05)
Diluted	$ (0.00)	$ 0.03	$ 0.05	$ (0.05)
Weighted average shares outstanding:				
Basic	28,815	29,156	30,366	30,554
Diluted	28,815	29,163	30,786	30,554

21. SUBSEQUENT EVENTS

On January 19, 2006, we borrowed $4 million from Max Azria pursuant to the terms of a promissory note, which amount bears interest at the rate of 5.5% per annum and is payable in weekly installments of $200,000 beginning on March 1, 2006. This is an unsecured loan.

On January 23, 2006, we further amended our factoring agreement with GMAC 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 will be reduced to $4 million on April 1, 2006 and will be further reduced to $3 million on July 1, 2006. The maximum borrowing availability under the factoring agreement, based on the borrowing base formula remains at $40 million.

On January 27, 2006, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from January 31, 2006 to July 31, 2006. The amendment provides for reduction of the maximum amount of borrowings under the facility to $12.0 million commencing on April 1, 2006, $11.5 million commencing on May 1, 2006, $11.0 million commencing on June 1, 2006 and to $10.5 million commencing on July 1, 2006. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of $25 million as of December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of $800,000.

In March 2006, we terminated our license agreement for the brand House of Dereon by Tina Knowles branded apparel, and sold our remaining inventory to the licensor. 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 agreement and recognized a loss accordingly in 2005. The loss was classified as royalty expense on our consolidated statements of operations.

In March 2006, we became involved in a dispute with the master licensor of the JS by Jessica Simpson, Princy and Sweet Kisses brands over our continued rights to these brands. Accordingly, we do not anticipate sales of Jessica Simpson branded apparel unless and until we successfully resolve our dispute with the licensor. Net sales of Jessica Simpson and Princy by Jessica Simpson totaled $12.6 million in 2005.

SCHEDULE II

TARRANT APPAREL GROUP

VALUATION AND QUALIFYING ACCOUNTS

	BALANCE AT BEGINNING OF YEAR	ADDITIONS CHARGED TO COSTS AND EXPENSES	ADDITIONS CHARGED TO OTHER ACCOUNTS	DEDUCTIONS

For the year ended December 31, 2003				
Allowance for returns and discounts...	$ 3,134,768	$ --	$ --	$ (324,387)
Allowance for bad debt	$ 1,181,853	$ 234,149	$ --	$ --
Inventory reserve	$ --	$10,986,153	$ --	$ --
	===========	===========	===========	===========
For the year ended December 31, 2004				
Allowance for returns and discounts ..	$ 2,810,381	$ 738,326	$ --	$(2,485,386)
Allowance for bad debt	$ 1,416,002	$ 476,016	$ --	$ (517,474)
Inventory reserve	$10,986,153	$ --	$ --	$(9,869,491)
	===========	===========	===========	===========
For the year ended December 31, 2005				
Allowance for returns and discounts ..	$ 1,063,321	$ 871,208	$ --	$ (949,268)
Allowance for bad debt	$ 1,374,544	$ 637,210	$ --	$ (45,265)
Inventory reserve	$ 1,116,662	$ --	$ --	$(1,032,836)
	===========	===========	===========	===========

AMERICAN RAG
COMBINED FINANCIAL STATEMENTS
FOR THE YEAR ENDED
DECEMBER 31, 2005

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
American Rag
Montebello, California

We have audited the accompanying combined balance sheet of American Rag (the "Company") and its combined affiliate as of December 31, 2005 and the related combined statements of income, stockholders' equity/members' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of American Rag and its combined affiliate as of December 31, 2005 and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, the accompanying combined financial statements for the year ended December 31, 2005 have been restated.

/s/ Singer Lewak Greenbaum & Goldstein LLP

SINGER LEWAK GREENBAUM & GOLDSTEIN LLP

Los Angeles, California
September 26, 2007

AMERICAN RAG
COMBINED BALANCE SHEET
DECEMBER 31, 2005
RESTATED

ASSETS	
CURRENT ASSETS	
Cash and cash equivalents	$ 149,136
Accounts receivable	43,654
Accounts receivable from member	41,000
Note receivable from member	75,000
Inventory, net	1,571,458
Prepaid expenses and other current assets	9,141
Total current assets	1,889,389
PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization	480,540
DEPOSITS	64,848
TOTAL ASSETS	$2,434,777
LIABILITIES AND STOCKHOLDERS' EQUITY/MEMBERS' EQUITY	
CURRENT LIABILITIES	
Accounts payable	$ 282,748
Accrued expenses	209,143
Unearned revenue	22,816
Deferred rent - current portion	4,232
Notes payable	114,629
Current maturities on obligations under capital lease	7,782

Total current liabilities	641,350
OBLIGATIONS UNDER CAPITAL LEASE, LESS CURRENT MATURITIES	19,462
DEFERRED RENT - LONG TERM PORTION	64,153
Total liabilities	724,965
STOCKHOLDERS' EQUITY/MEMBERS' EQUITY	
American Rag Compagnie, Inc.	316,910
American Rag CIE, LLC	1,392,902
Total stockholders' equity/members' equity	1,709,812
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY/MEMBERS' EQUITY	$2,434,777

The accompanying notes are an integral part of these financial statements

AMERICAN RAG
COMBINED STATEMENT OF INCOME
FOR THE YEAR ENDED DECEMBER 31, 2005
RESTATED

NET SALES	$10,125,563
COST OF SALES	5,032,855
GROSS PROFIT	5,092,708
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	4,507,227
INCOME FROM OPERATIONS	585,481
INTEREST EXPENSE	17,433
OTHER INCOME (EXPENSE)	602,449
INCOME BEFORE INCOME TAXES	1,170,497
INCOME TAXES	18,066
NET INCOME	$ 1,152,431

The accompanying notes are an integral part of these financial statements

COMBINED STATEMENT OF STOCKHOLDERS' EQUIT
FOR THE YEAR ENDED

	American Rag CIE, LLC	American Rag Compagnie, Inc.			
	Members' Equity	Common Stock (a)		Additional Paid-in Capital	Retaine Earning
	Amount	Shares Outstanding	Amount		
Balance at January 1, 2005 .	$ 1,216,807	10,870	$ 100,000	$ 2,618	$ 215,9
Distributions	(977,958)	--	--	--	--
Net income (loss)	1,154,053	--	--	--	(1,6
Balance at December 31, 2005	$ 1,392,902	10,870	$ 100,000	$ 2,618	$ 214,2

(a) Common stock, no par value, 500,000 shares authorized and 10,870 shares issued at January 1, 2005 and December 31, 2005.

The accompanying notes are an integral part of these financial statements

AMERICAN RAG
COMBINED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2005
RESTATED

CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES	
Net income	$ 1,152,431
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES	
Depreciation and amortization	76,241

CHANGES IN ASSETS AND LIABILITIES	
(INCREASE) DECREASE IN ASSETS	
Accounts receivable	(11,983)
Accounts receivable from members	60,495
Inventory	(356,472)
Prepaid expenses and other current assets	6,820
Deposits	(30,813)
INCREASE (DECREASE) IN LIABILITIES	
Accounts payable	(96,740)
Accrued expenses	74,461
Deferred Rent	68,385
Unearned revenue	22,816
Net cash provided by operating activities	965,641
CASH FLOWS (USED IN) INVESTING ACTIVITIES	
Payments to acquire property and equipment	(22,111)
Net cash used in investing activities	(22,111)
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES	
Note receivable from member	300,000
Payments on capital lease obligations	(6,370)
Payments on notes payable	(149,239)
Distributions to members	(977,958)
Net cash used in financing activities	(833,567)
NET INCREASE IN CASH	109,963
CASH, beginning of year	39,173
CASH, end of year	$ 149,136
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION	
Interest paid	$ 17,433
Taxes paid	$ 13,390

The accompanying notes are an integral part of these financial statements

AMERICAN RAG
NOTES TO COMBINED FINANCIAL STATEMENTS
DECEMBER 31, 2005
RESTATED

NOTE 1 - NATURE OF BUSINESS, OWNERSHIP AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS

BUSINESS ACTIVITY
The Company imports and operates retail men's and women's Avante-Garde lifestyle clothing, including emerging designers, jeans wear, shoes, accessories, home furnishings, vintage clothing, CDs and other related items, in its Los Angeles and San Francisco stores.

PRINCIPLES OF COMBINATION AND BASIS OF PRESENTATION
The combined financial statements include the accounts of American Rag CIE, LLC and American Rag Compagnie, Inc., collectively referred to as "American Rag" or the "Company," which are affiliated by virtue of common ownership. All significant intercompany transactions and related party balances have been eliminated in combination.

OWNERSHIP
American Rag CIE, LLC is a California limited liability company that was formed on June 19, 2003, with a term through December 15, 2080. 55% of American Rag CIE, LLC is owned by American Rag CIE II, Inc. and 45% owned by Tarrant Apparel Group.

American Rag Compagnie, Inc. was incorporated on July 6, 1984, and is a C Corporation.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

FAIR VALUE
Unless otherwise indicated, the fair values of all reported assets and liabilities, which represent financial instruments, none of which are held for trading purposes, approximate carrying values of such amounts.

USE OF ESTIMATES
The preparation of combined financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

REVENUE RECOGNITION
The Company recognizes revenue upon the sale of retail merchandise, net of returns and discounts.

COST OF SALES
Cost of sales includes cost related to product costs, and freight in.

NOTE 1 - NATURE OF BUSINESS OWNERSHIP AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES
Selling, general and administrative expenses include expenses related to salaries, rent, insurance, bank charges, travel and entertainment, professional fees, depreciation and amortization, and other office expenses.

UNEARNED REVENUE
The Company records unearned revenue in the accompanying balance sheet on gift cards sold but not redeemed by customers at the end of the year.

DEFERRED RENT
The Company records rent expense related to its non-cancelable operating leases on a straight line basis over the initial term of the lease. The difference between the average rental amount charged to expense and amounts payable under the lease is included in deferred rent in the accompanying balance sheet.

ADVERTISING
The Company expenses advertising costs, consisting primarily of placement in multiple publications, along with design and printing costs of sales materials.

Advertising expense for the year ended December 31, 2005 amounted to $6,792.

CASH AND CASH EQUIVALENTS
The Company maintains its cash balances in high credit quality financial institutions; balances, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. For purposes of reporting the statement of cash flows, the Company considers all cash accounts, which are not subject to withdrawal restrictions or penalties, and all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

INVENTORY
Inventory is valued at the lower of cost or market on a first-in, first-out basis. Inventory consists of men's and women's Avante-Garde lifestyle clothing, including emerging designers, jeans wear, shoes, accessories, home furnishings, vintage clothing, CDs and other related items.

ACCOUNTS RECEIVABLE
Accounts receivable are receivables outstanding from commercial buyers. Accounts receivable are evaluated on an item-by-item basis and are written-off if deemed uncollectible.

NOTE 1 - NATURE OF BUSINESS OWNERSHIP AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost. Depreciation and amortization are provided by the use of straight-line and accelerated methods over the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the lesser of their estimated useful lives or the term of the lease.

INCOME TAXES

American Rag Compagnie, Inc. is a California C Corporation with a fiscal year-end of December 31.

The Company recognizes deferred tax assets and liabilities with respect to the tax consequences attributable to the differences between the financial statements carrying values and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which these temporary differences are expected to be recovered or settled. Further, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets and liabilities are immaterial.

The Company has a California net operating loss carry forward of $50,034 which expires in 2013.

American Rag CIE, LLC, and its members, elected income tax status as a limited liability company from its inception. Under this election, members of the American Rag CIE, LLC are personally liable for federal and state income taxes. American Rag CIE, LLC is liable for its state taxes based on revenues.

NOTE 2 - RESTATED FINANCIAL STATEMENTS

The Company has restated its financial statements as of the year ended December 31, 2005 and the related notes to the financial statements.

This restatement is to correct errors identified in: (a) the revenue recognition related to gift cards sold that were recorded as revenue rather than an unearned revenue. The revenue has been corrected to reflect recognition of the revenue as the gift cards are used. (b) the Company had not record its operating lease expense on a straight-line basis as required under GAAP. The statements have been restated to correct this accounting treatment.

The following table shows the impact of these restatements on the financial statements as of and for the year ended December 31, 2005.

	PREVIOUSLY REPORTED DECEMBER 31, 2005	ADJUSTMENTS	RESTATED DECEMBER 31, 2005
BALANCE SHEET			
Deferred rent - current portion	$ --	$ 4,232	$ 4,232
Deferred rent - long term portion	--	64,153	64,153
Unearned revenue	--	22,816	22,816
TOTAL LIABILITIES	633,764	91,201	724,965
American Rag Compangnie, Inc.	322,981	(6,071)	316,910
American Rag CIE, LLC	1,478,032	(85,130)	1,392,902
TOTAL STOCKHOLDER'S EQUITY	$ 1,801,013	$ (91,201)	$ 1,709,812
STATEMENT OF CASH FLOWS			
Deferred rent	$ --	$ 68,385	$ 68,385
Unearned revenue	$ --	$ 22,816	$ 22,816
STATEMENT OF INCOME			
Net sales	$10,148,379	$ (22,816)	$10,125,563
Selling, general and administrative expenses	4,438,842	68,385	4,507,227
Net income	$ 1,243,632	$ (91,201)	$ 1,152,431

NOTE 3 - ACCOUNT RECEIVABLE FROM MEMBER

As of December 31, 2005, there was an outstanding, non-interest bearing advance to one of the members for $41,000. The advance was to be repaid before the end of the following year.

NOTE 4 - NOTE RECEIVABLE FROM MEMBER

Effective June 19, 2003, American Rag CIE, LLC received a capital contribution and a note receivable in the amount of $1,000,000 from a member who has a 45% ownership in American Rag CIE, LLC. Payments totaling $925,000 were received through December 31, 2005. At December 31, 2005, the balance on the note receivable was $75,000. The final payment is due March 31, 2006 with interest at 4% per annum. The note is secured by the member's interest in American Rag CIE, LLC.

NOTE 5 - INVENTORY

Inventory consists of men's and women's Avante-Garde lifestyle clothing, including emerging designers, jeans wear, shoes, accessories, home furnishings, vintage clothing, CDs and other related items.

NOTE 6 - PROPERTY AND EQUIPMENT

A summary is as follows:

Furniture and equipment	$ 912,508
Leasehold improvements	764,029
Automobiles	114,359
Hydraulic press and forklift	31,085
	1,821,981
Less accumulated depreciation and amortization	1,341,441
	$ 480,540

Depreciation and amortization for the year ended December 31, 2005 was $76,241.

NOTE 7 - DEPOSIT

The Company paid security deposits on leased facilities. At December 31, 2005, the Company had paid $64,848.

NOTE 8 - NOTE PAYABLE

The Company may borrow up to $250,000 under a revolving line of credit agreement expiring June 3, 2006. Interest is payable monthly at prime plus 1%. At December 31, 2005, the Company had borrowings of $88,045.

The Company entered into a note for $300,000 bearing interest at prime plus 1% and is due on May 8, 2006. Monthly payments of $9,037 include variable interest, as charged on the outstanding debt, with the remaining portion of the payment consisting of principal. At December 31, 2005, the Company had borrowings of $26,584.

The notes are secured by all assets of the Company and by personal guaranties from the majority stockholders.

A summary is as follows:

Line of credit ...	$ 88,045
Note payable, bank	26,584
	$114,629

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NOTE 9 - OBLIGATION UNDER CAPITAL LEASE

The Company leases an automobile from an unrelated party under terms of a capital lease at an annual interest rate of 6.85% payable in installments through 2009. The lease is secured by the related automobile costing $40,122 with accumulated depreciation of $15,625 at December 31, 2005. Interest expense on the capital lease amounted to $2,176 for the year ended December 31, 2005.

The following is a schedule by years of future minimum principal payments required under the capital lease:

Year ending December 31,	
2006	$ 9,027
2007	9,027
2008	9,027
2009	1,699
Total minimum lease payments	28,780
Less amounts representing interest	1,536
Present value of minimum lease payments	27,244
Less current maturities	7,782
	$ 19,462

NOTE 10 - RELATED PARTY

The Company rents office space from HKW Partners on a month to month basis at a rate of $2,500. HKW Partners is beneficially owned by one of the members.

NOTE 11 - LICENSING AGREEMENT

On April 1, 2003, the Company entered into an agreement to license the use of the American Rag trademark to Tarrant Apparel Group's related company, allowing the licensee to manufacture and sell apparel and accessories under this trademark. The term of the license is from April 1, 2003 to December 31, 2013, and the licensee may elect to renew for three consecutive ten-year periods on the same terms and conditions. The license calls for the licensee to make royalty payments to the Company of 2.05% of net sales of all licensee products in the United States, Canada, Mexico, and Bermuda, and 4% of net sales of all licensed products worldwide, except Japan, with guaranteed minimum annual royalty payments as follows:

YEAR	GUARANTEED MINIMUM ROYALTY
2006	$ 661,250
2007	760,438
2008	874,504
2009	1,005,680
2010	1,156,532
2011	1,330,012
2012	1,529,514
2013	1,750,000
Total	$ 9,067,930
Annually thereafter	$ 1,750,000

Royalty income amounted to the minimum guaranteed royalty payment of $575,000 for the year ended December 31, 2005.

NOTE 12 - COMMITMENTS

The Company conducts its operations in leased facilities under operating leases expiring at various dates. Certain of these leases contain base rent escalation as well as renewal provisions. 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. The following is a schedule by years based on cash payments on future minimum rental payments required under the operating leases that have non-cancelable lease terms in excess of one year as of December 31, 2005:

	OPERATING LEASES	SUBLEASE INCOME	TOTAL
Year ending December 31,			
2006	$ 726,625	$ 54,500	$ 672,125
2007	737,950	-	737,950
2008	658,440	-	658,440
2009	493,016	-	493,016
2010	376,499	-	376,499
After 2010	2,164,871	-	2,164,871
	$ 5,157,401	$ 54,500	$ 5,102,901

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Rent is adjusted annually based on increases in the Consumer Price Index, if any, and payments of certain additional expenses including utilities, property taxes and other operating expenses is required. Certain leases provide for renewal options.

Rent expense charged to operations amounted to $842,398 for the year ended December 31, 2005. As of December 31, 2005, deferred rent of $68,385 was recorded in the Company's combined balance sheet.

Sublease rental income amounted to $101,012 for the year ended December 31, 2005.

The Company also rents office space from HKW Partners on a month to month basis at a rate of $2,500. HKW Partners is beneficially owned by one of the members.

NOTES 13 - SUBSEQUENT EVENTS

NEW STORE LOCATION
In September 2006, the Company opened a new store in the Fashion Island shopping center in Newport Beach, California.

LEASE AMENDMENT
In June 2007, the Company amended the lease for its Fashion Island location. The Company will pay rent at the rate of 12% of sales effective March 1, 2007. The difference between that amount and the prior rental rate will be deferred until the store achieves annualized sales that exceed $5,500,000.

BANK LINE OF CREDIT / NOTES PAYABLE - CALIFORNIA UNITED BANK
In June 2006, the Company negotiated a new bank line and note facility. The terms are summarized as follows:

Line of credit facility of $500,000, secured by substantially all of the Company's assets, payable in full on maturity date April 15, 2007 at 8% per annum;

Note payable facility of $500,000, secured by substantially all of the Company's assets, payable in equal monthly installments of $13,889 plus interest of 8.50% through maturity of December 15, 2009;

Note payable facility of $500,000, secured by substantially all of the Company's assets, payable in equal monthly installments of $13,889, commencing July 15, 2007, plus interest of 8.50% through maturity at June 15, 2010.

The Company is in the process of renewing the line of credit facility.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

By: /S/ GERARD GUEZ

Gerard Guez
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/S/ GERARD GUEZ Gerard Buez	Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)	October 10, 2007
/S/ DAVID BURKE David Burke	Chief Financial Officer (Principal Financial and Accounting Officer)	October 10, 2007
* Todd Kay	Vice Chairman of the Board of Directors	October 10, 2007
* Milton Koffman	Director	October 10, 2007
* Stephane Farouze	Director	October 10, 2007
* Mitchell Simbal	Director	October 10, 2007
* Joseph Mizrachi	Director	October 10, 2007
* Simon Mani	Director	October 10, 2007

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* By: /S/ GERARD GUEZ
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      Gerard Guez, As Attorney-In-Fact
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