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NITCHES INC
Form 10-Q
April 14, 2004

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended: February 29, 2004

Commission File Number 0-13851

NITCHES, INC.

(Exact name of registrant as specified in its charter)

California
(State of Incorporation)

95-2848021
(I.R.S. Employer Identification No.)

10280 Camino Santa Fe, San Diego, California 92121
(Address of principal executive offices)

Registrant's telephone number: (858) 625-2633

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

| Title of each class ----- | Name of each exchange on which registered ----- |
|------------------------------|---|
| Common Stock, no par value | NASDAQ SmallCap Market |

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

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

As of February 29, 2004 the Registrant had 1,171,169 shares of common stock outstanding.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

NITCHES, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets

ASSETS

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| | February 29, 2004 | August 31, 2003 |
|--|----------------------|--------------------|
| | ----- (Unaudited) | ----- |
| Current assets: | | |
| Cash and cash equivalents | \$ 205,000 | \$ 110,000 |
| Receivables: | | |
| Trade accounts, less allowances | 1,767,000 | 894,000 |
| Due from affiliates and employees | 11,000 | 28,000 |
| | ----- | ----- |
| Total receivables | 1,778,000 | 922,000 |
| Refundable income taxes | -- | 466,000 |
| Inventories | 6,042,000 | 4,974,000 |
| Deferred income taxes | 192,000 | 192,000 |
| Other current assets | 39,000 | 57,000 |
| | ----- | ----- |
| Total current assets | 8,256,000 | 6,721,000 |
| Investment in Designer Intimates, Inc. | 174,000 | -- |
| Furniture, fixtures and equipment, net | 47,000 | 56,000 |
| Deferred income taxes | 53,000 | 53,000 |
| Other assets | 17,000 | 17,000 |
| | ----- | ----- |
| | \$ 8,547,000 | \$ 6,847,000 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,707,000 | \$ 1,525,000 |
| Accrued expenses | 936,000 | 182,000 |
| Due to affiliates | 15,000 | -- |
| Income taxes payable | 211,000 | -- |
| | ----- | ----- |
| Total current liabilities | 2,869,000 | 1,707,000 |
| Long term liabilities: | | |
| Loss on investment in Designer Intimates, Inc. | | 236,000 |
| Shareholders' equity: | | |
| Preferred stock, no par value; 25,000,000 shares authorized, no shares issued or outstanding | -- | -- |
| Common stock, no par value; 50,000,000 shares authorized; 1,171,169 shares issued and outstanding | 1,495,000 | 1,495,000 |
| Retained earnings | 4,183,000 | 3,409,000 |
| | ----- | ----- |
| Total shareholders' equity | 5,678,000 | 4,904,000 |
| | ----- | ----- |
| | \$ 8,547,000 | \$ 6,847,000 |
| | ===== | ===== |

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

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| | Three Months Ended | | Six Months Ended | |
|--|----------------------|----------------------|----------------------|----------------------|
| | February 29, 2004 | February 28, 2003 | February 29, 2004 | February 28, 2003 |
| Net sales | \$ 9,683,000 | \$ 6,699,000 | \$ 16,479,000 | \$ 10,000,000 |
| Cost of goods sold | 6,623,000 | 4,958,000 | 11,687,000 | 7,500,000 |
| Gross profit | 3,060,000 | 1,741,000 | 4,792,000 | 2,500,000 |
| Selling, general and administrative expenses | 2,458,000 | 1,865,000 | 4,145,000 | 2,500,000 |
| Income/(loss) from operations | 602,000 | (124,000) | 647,000 | 0 |
| Interest and other income | -- | 3,000 | -- | 3,000 |
| Interest expense | (32,000) | (33,000) | (43,000) | (33,000) |
| Income/(loss) from unconsolidated subsidiary | (58,000) | (61,000) | 410,000 | 410,000 |
| Income/(loss) before income taxes | 512,000 | (215,000) | 1,014,000 | 410,000 |
| Provision/(benefit) for income taxes | 227,000 | (60,000) | 240,000 | 240,000 |
| Net income/(loss) | \$ 285,000 | \$ (155,000) | \$ 774,000 | \$ 680,000 |
| Earnings per share | \$ 0.24 | \$ (0.13) | \$ 0.66 | \$ 0.66 |
| Shares outstanding | 1,171,169 | 1,171,169 | 1,171,169 | 1,171,169 |
| Dividends per share | \$ -- | \$ 0.15 | \$ -- | \$ -- |

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

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NITCHES, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

| | Six Months Ended | |
|---------------------------------------|----------------------|----------------------|
| | February 29, 2004 | February 28, 2003 |
| Net income | \$ 774,000 | \$ 305,000 |
| Cash flows from operating activities: | | |

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| | | |
|---|------------|-------------|
| Depreciation and amortization | 13,000 | 17,000 |
| (Increase) decrease in accounts receivable | (856,000) | 1,038,000 |
| (Increase) decrease in inventories and other current assets | (584,000) | 1,804,000 |
| Increase (decrease) in trade payables and accrued expenses | 1,162,000 | (2,611,000) |
| Non-cash income from unconsolidated subsidiary | (410,000) | (227,000) |
| | ----- | ----- |
| Net cash provided by operating activities | \$ 99,000 | \$ 326,000 |
| Cash flows from investing activities: | | |
| Capital expenditures | (4,000) | (4,000) |
| Cash flows from financing activities: | | |
| Dividends paid | -- | (234,000) |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | 95,000 | 88,000 |
| Cash and cash equivalents at beginning of period | 110,000 | 182,000 |
| | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 205,000 | \$ 270,000 |
| | ===== | ===== |
| Supplemental disclosures of cash flow information: | | |
| Cash paid (received) during the period: | | |
| Interest | \$ 43,000 | \$ 62,000 |
| Income taxes | (436,000) | -- |
| Non-cash investing activity: | | |
| Accrued earnings of unconsolidated subsidiary | \$ 410,000 | \$ 227,000 |

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

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NITCHES, INC. AND SUBSIDIARIES Notes to Condensed Consolidated Financial Statements

1. Description of Business

Nitches, Inc. (the "Company") is a wholesale importer and distributor of clothing manufactured to its specifications and distributed in the United States under Company brand labels and private retailer labels. The Company's product lines include women's sleepwear and western wear, men's casual wear and men's and women's performance apparel.

2. Condensed Financial Statements:

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q. They do not include all information and footnotes necessary for a fair presentation of financial position and results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended August 31, 2003. In the opinion of Management, all adjustments considered necessary for a fair presentation have been included in the interim period. Operating results for the six months ended February 29, 2004 are not necessarily indicative of the results that may be expected for the year ending August 31, 2004.

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3. Earnings Per share:

At February 29, 2004, there were no stock options or similar instruments outstanding and therefore no dilutive effect to the number of shares outstanding.

4. Inventories:

| | February 29, 2004 | August 31, 2003 |
|------------------|----------------------|--------------------|
| | ----- | ----- |
| Fabric and trim | \$ 369,000 | \$ 320,000 |
| Work in progress | 1,204,000 | 1,254,000 |
| Finished goods | 4,469,000 | 3,400,000 |
| | ----- | ----- |
| | \$6,042,000 | \$4,974,000 |
| | ===== | ===== |

5. Trade accounts receivable:

Pursuant to the terms of an agreement between Nitches and a factor, Nitches sells a majority of its trade accounts receivable to the factor on a pre-approved, non-recourse basis. The price at which the accounts are sold is the invoice amount reduced by the factor commission (.3% of the invoice amount) and all selling discounts. For accounts sold to the factor without recourse, the factor is responsible for collection, assumes all credit risk, and obtains all of the rights and remedies against the company's customers. For such accounts, payment is due from the factor upon the earlier of the payment of the receivable to the factor by the customer, or the maturity of the receivable (generally 180 days from the date of shipment to the customer). As of February 29, 2004, non-recourse receivables totaled \$1,999,000.

Trade accounts receivable not sold to the factor remain in the custody and control of the Company and the Company maintains all credit risk on those accounts as well as accounts which are sold to the factor with recourse. The combined credit risk for non-factored and recourse receivables as of February 29, 2004, totaled \$256,000.

The Company may request payment from the factor in advance of the collection date or maturity. Any such advance payments are assessed an interest charge through the collection date or maturity at the factor's prime rate less 1.5% (one and one half percent) per annum. The company's obligations with respect to advances from the factor are limited to the interest charges thereon. Advance payments are limited to a maximum of 85% (eighty-five percent) of eligible accounts receivable. The factoring agreement also provides for the issuance of irrevocable letters of credit for the Company's purchase of inventory in the normal course of its business. Letters of credit are subject to a \$6 million limit. All assets of the company collateralize the advances and letters of credit. The Company's Chairman has also provided a personal guaranty in connection with the factoring arrangement.

5. Trade accounts receivable (continued):

The status of the trade accounts receivable and letters of credit are as

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follows:

| | February 29, 2004 | August 31, 2003 |
|--|----------------------|--------------------|
| | ----- | ----- |
| Receivables assigned to factor: | | |
| Non-recourse | \$ 9,154,000 | \$ 2,599,000 |
| Recourse | 4,000 | 16,000 |
| Advance payments from factor | (7,155,000) | (1,542,000) |
| | ----- | ----- |
| Due from factor | 2,003,000 | 1,073,000 |
| Non-factored accounts receivable | 265,000 | 370,000 |
| Allowance for customer credits and doubtful accounts | (501,000) | (549,000) |
| | ----- | ----- |
| | \$ 1,767,000 | \$ 894,000 |
| | ===== | ===== |
| Contingent liabilities for irrevocable letters of credit | \$ 1,456,000 | \$ 2,401,000 |
| | ===== | ===== |

6. Dividends:

The Company did not pay any dividends during the current period. During fiscal 2003 the Company declared and paid dividends of \$.30 per share.

7. Significant Customers:

Sales to Wal-Mart and Kohl's accounted for 45.4% and 22.8%, respectively, of the company's net sales in the three months ended February 29, 2004. By comparison, sales to Kohl's, Mervyn's and Sears accounted for 28.1%, 24.1% and 10.4%, respectively, of the Company's net sales in the three months ended February 28, 2003. For the six months ended February 29, 2004, sales to Kohl's and Wal-Mart accounted for 34.0% and 26.7%, respectively, of the Company's net sales. Kohl's, Mervyn's and Sears accounted for 34.6%, 25.0% and 20.0%, respectively, of the Company's net sales for the six months ended February 28, 2003.

Two customers, Wal-Mart and Kohl's, accounted for 59.1% and 16.5% respectively of the Company's trade receivable balance as of February 29, 2004. Two customers, Kohl's and Mervyn's, accounted for 30.1% and 25.0%, respectively, of the Company's trade receivable balance at February 28, 2003.

8. Minority Interest:

In October 2002 the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guarantee formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For the six months ended February 29, 2004, the Company recognized \$410,000 in income from the unconsolidated subsidiary. This income is reported net of tax and is not taxable to the Company. For that same period, Designer Intimates had net income of \$1,465,000 on sales of \$49.2 million.

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Following are the unaudited condensed financial statements of Designer Intimates, Inc. as of February 29, 2004 for the 6-month period then ended:

Designer Intimates, Inc.
Consolidated Balance Sheet
(Unaudited)

ASSETS

| | February 29, 2004 |
|--|----------------------|
| | ----- (Unaudited) |
| Current assets: | |
| Cash and cash equivalents | \$ 403,000 |
| Trade accounts receivable, less allowances | 1,385,000 |
| Inventories | 2,849,000 |
| Deferred income taxes | 200,000 |
| Other current assets | 84,000 |
| | ----- |
| Total current assets | 4,921,000 |
| | |
| Furniture, fixtures and equipment, net | 727,000 |
| Goodwill | 2,548,000 |
| Other intangibles, subject to amortization | 295,000 |
| Other assets | 95,000 |
| | ----- |
| | \$ 8,586,000 |
| | ===== |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | |
|----------------------------|--------------|
| Current liabilities: | |
| Loan payable | \$ 505,000 |
| Accounts payable | 5,369,000 |
| Accrued expenses | 859,000 |
| Income taxes payable | 1,227,000 |
| | ----- |
| Total current liabilities | 7,960,000 |
| | |
| Shareholders' equity: | |
| Common stock | 3,000 |
| Retained earnings | 623,000 |
| | ----- |
| Total shareholders' equity | 626,000 |
| | ----- |
| | \$ 8,586,000 |
| | ===== |

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Designer Intimates, Inc.
Consolidated Income Statement
(Unaudited)

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Six Months Ended
February 29, 2004

| | |
|--------------------------------------|---------------|
| Net Sales | \$ 49,225,000 |
| Cost of sales | 39,105,000 |
| | ----- |
| Gross profit | 10,120,000 |
| Operating expenses | 7,333,000 |
| Amortization of intangible assets | 93,000 |
| | ----- |
| Income from operations | 2,694,000 |
| Interest expenses | 145,000 |
| Other (income) | (16,000) |
| | ----- |
| Income/(loss) before income taxes | 2,565,000 |
| Provision/(benefit) for income taxes | 1,100,000 |
| | ----- |
| Net income/(loss) | \$ 1,465,000 |
| | ===== |

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

CRITICAL ACCOUNTING POLICIES

Revenue Recognition. The Company recognizes revenue at the time products are shipped based on its terms of F.O.B. shipping point, where risk of loss and title transfer to the buyer at time of shipment. The Company records sales in accordance with SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements. Under these guidelines, revenue is recognized when all of the following exist: persuasive evidence of a sale arrangement exists, delivery of the product has occurred, the price is fixed or determinable and payment is reasonably assured. Provisions are made currently for estimated product returns and sales allowances.

Allowances for Sales Returns, Doubtful Accounts and Other. Sales are recorded net of estimated future returns, uncollectible accounts receivable and other customer related allowances. Management analyzes historical returns and bad debt expense, current economic trends, changes in customer demand and sell-through of our products when evaluating the adequacy of these allowances. In addition, the Company may provide warehousing credits and other allowances to certain customers in accordance with industry practice. These reserves are determined based on historical experience, budgeted customer allowances and existing commitments to customers. Although management believes it has established adequate reserves with respect to these items, actual activity could vary from management's estimates and such variances could have a material impact on reported results. At February 29, 2004, trade accounts receivable balance was \$1.8 million, net of allowances of \$501,000, as compared to the balance of \$0.9 million, net of allowances of \$549,000 at August 31, 2003. At February 28, 2003, the trade accounts receivable balance was \$3.4 million, net of allowances for doubtful accounts of \$222,000.

Inventory. The Company marks down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated net realizable value based on assumptions about age of the inventory, future demand and market conditions. This process provides for a new basis for the inventory until it is sold. If actual market conditions are less favorable than those projected by management, additional inventory markdowns may be required. The Company's inventory balance was \$6.0 million, net of inventory markdowns of \$203,000, at February 29, 2004, as compared to an inventory balance

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of \$5.0 million, net of inventory write-downs of \$140,000, at August 31, 2003. At February 28, 2003, the inventory balance was \$3.4 million, net of inventory write-downs of \$155,000.

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Results of Operations

Six Months Ended February 29, 2004 Compared to the Six Months Ended February 28, 2003

Net sales of \$16.5 million for the six months ended February 29, 2004, decreased approximately \$677,000 (3.9%) as compared to net sales of \$17.2 million for the six months ended February 28, 2003. This decrease was attributable to a decrease in unit sales of the Company's sleepwear product line, offset partially by an increase in unit sales of the Company's men's wear product line.

Cost of sales as a percent of net sales declined 7.7%, generating a higher gross profit margin of 29.1% for the six months ended February 29, 2004, as compared to 21.4% for the year earlier period. The Company realized higher gross margins due to increased sales of higher margin branded men's product and decreased sales of lower margin private label women's sleepwear. However, the Company's product mix constantly changes to reflect customer mix, fashion trends and changing seasons. Consequently, gross margin is likely to vary on a quarter-to-quarter basis and in comparison to gross margins generated in the same period of prior fiscal years.

Selling, general and administrative expenses for the first half of fiscal 2004 increased \$483,000 as compared to a year ago, due primarily to an increase in sales commissions and selling related expenses incurred in the second quarter, in line with an increase in men's wear product sales. Selling, general and administrative expenses include costs and expenses pertaining to selling, merchandising, warehousing, and shipping of products. For the six months ended February 29, 2004, this category included \$2,411,000 of selling and merchandising expenses and \$625,000 of shipping and warehousing expenses. This compares with \$1,555,000 of selling and merchandising expenses and \$705,000 of shipping and warehousing expenses incurred for the six months ended February 28, 2003. Expenses increased as a percent of net sales to 25.2% from 21.3% in the year earlier period, due to the increase in sales commissions and selling expenses for the men's wear product line.

Interest expense declined \$19,000 for the current period to \$43,000 as compared to \$62,000 for the six months ended February 28, 2003. This decrease was due to the lower interest rate charged on advances made under the Company's factoring agreement.

The Company's income tax provision for the six months of fiscal 2004 reflects the effect of a \$240,000 tax expense accrued at an estimated 39% tax rate, in line with the actual tax rate experienced by the Company. The tax provision for the six months of fiscal 2003 reflects the effect of a \$19,000 tax benefit accrued at an estimated 39% tax rate, less the elimination of a deferred tax reserve in the amount of \$109,000, for a net tax benefit of \$128,000.

Three Months Ended February 29, 2004 Compared to the Three Months Ended February 28, 2003

Net sales of \$9.7 million for the three months ended February 29, 2004, increased approximately \$3.0 million (44.5%) over net sales of \$6.7 million for the three months ended February 28, 2003. This increase was attributable to an

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increase in unit sales in the Company's men's wear product line.

Cost of sales as a percent of net sales declined 5.6%, generating a higher gross profit margin of 31.6% for the three months ended February 29, 2004 as compared to 26.0% for the year earlier period. The increase came as the result of increased sales volume in higher margin men's wear product. The Company's product mix constantly changes to reflect customer mix, fashion trends and changing seasons. Consequently, gross margin is likely to vary on a quarter-to-quarter basis and in comparison to gross margins generated in the same period of prior fiscal years.

Selling, general and administrative expenses for the second quarter of fiscal 2004 rose \$593,000 as compared to a year ago, due primarily to an increase in sales commissions and selling related expenses in line with the higher sales volume in the Company's men's wear product line. Expenses included \$1,350,000 of selling and merchandising expenses and \$348,000 of shipping and warehousing expenses. This compares with \$831,000 of selling and merchandising expenses and \$315,000 of shipping and warehousing expenses incurred during the quarter ended February 28, 2003. Expenses decreased as a percent of net sales to 25.4% from 27.8% in the year earlier period, due to the proportionally larger increase in sales from the earlier period.

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Interest expense decreased \$1,000 in the current quarter to \$32,000 as compared to \$33,000 for the three months ended February 28, 2003. This slight decline was due to the lower interest rate charged on advances made under the Company's factoring agreement.

The Company's income tax provision for the three months ended February 29, 2004, reflects a \$227,000 tax expense accrued at an estimated 39.8% tax rate on pretax income for the quarter of \$571,000, which excludes the \$58,000 loss on the investment in Designer Intimates because this loss is reported net of tax and is not taxable to the Company. The Company also utilized an estimated tax rate of 39% for the three months ended February 28, 2003. There were no tax reserve write-offs or other tax adjustments in either period.

Investment in Unconsolidated Subsidiary

In October 2002, the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guarantee formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For the six months ended February 29, 2004, the Company recognized \$410,000 in income from the unconsolidated subsidiary. This income is reported net of tax and is not taxable to the Company. For that same period, Designer Intimates had net income of \$1,465,000 on sales of \$49.2 million.

Liquidity and Capital Resources

Working capital increased \$373,000 to \$5.4 million at February 29, 2004, from \$5.0 million at August 31, 2003. However, the current ratio decreased to 2.9:1 at February 29, 2004, from 3.9:1 at August 31, 2003, due to a higher

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percentage increase in current liabilities, 68.1% versus a 22.8% rise in current assets, in line with increased inventory purchases and operating expenses for the current period. At February 29, 2004, the Company's trade receivables balance was \$1.8 million, an increase of \$900,000 from the receivables balance at August 31, 2003, reflecting the increased sales volume for the current period.

The Company sells substantially all of its trade receivables to a factor (CIT) on a pre-approved, non-recourse basis. The Company attempts to make any recourse shipments on a COD basis or ensure that the customers' payments are backed by a commercial or standby letter of credit issued by the customers' bank. The amount of the Company's receivables that were recourse and were not made on a COD basis or supported by commercial or standby letters of credit at February 29, 2004 was approximately \$256,000, of which approximately \$48,000 had been collected through March 31, 2004.

Payment for non-recourse factored receivables is made at the time customers make payment to CIT or, if a customer is financially unable to make payment, within approximately 180 days of the invoice due date. Under the factoring agreement, the Company can request advances in anticipation of customer collections at the prime rate offered by CIT (currently 4.00%) less one and one-half percent (1.5%). The amount of advances available to the Company is limited to eighty-five percent (85%) of non-recourse factored receivables.

The Company may issue import letters of credit through HSBC for the purchase of inventory from overseas suppliers in the normal course of its operations. Letters of credit are subjected to a limit of \$6 million. At February 29, 2004, the Company had outstanding letters of credit of approximately \$1.5 million for the purchase of finished goods, which had been opened through HSBC.

The factoring agreement does not contain any financial covenants to which the Company must adhere. Advances are collateralized by all of the assets of the Company as well as a personal guaranty of the Company's Chairman. The factoring agreement can be terminated by CIT on 30-days written notice. The company believes the factoring agreement with CIT, the letter of credit agreement with HSBC, along with expected cash flow from operating activities and current levels of working capital, are adequate to fulfill the Company's liquidity needs for the foreseeable future.

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Contractual Obligations and Commercial Commitments

| | Total Committed | Payments due/Commitments expiring per period | | |
|---------------------------------|--------------------|--|-----------|-------------|
| | | Less than 1 year | 1-3 years | 4-5 years |
| Operating leases | \$ 134,000 | \$ 88,000 | \$ 46,000 | |
| Letters of credit | 1,456,000 | 1,456,000 | | |
| Guarantees | 3,000,000 | | | 3,000,000 |
| Total obligations & commitments | \$4,590,000 | \$1,544,000 | \$ 46,000 | \$3,000,000 |

Inventory

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The Company's inventory increased 21.5% to \$6.0 million at February 29, 2004, from \$5.0 million at August 31, 2003. Compared to inventories of \$3.4 million at February 28, 2003, inventories ending the current period increased 76%, primarily due to increased order backlog in the Company's men's wear line. The Company believes that its current inventory mix and amounts are appropriate to respond to anticipated market demand.

In its ordinary course of operations, the Company generally makes some sales below its normal selling prices or below cost. Based on prior experience, management believes this will be true for some inventory held on or acquired after February 29, 2004. The amount of such sales depends on several factors, including general economic conditions, market conditions within the apparel industry, the desirability of the styles held in inventory and competitive pressures from other garment suppliers.

The Company has established an inventory markdown reserve as of February 29, 2004, which management believes will be sufficient for current inventory that is expected to sell below cost in the future. There can be no assurance that the Company will realize its expected selling prices, or that the inventory markdown reserve will be adequate, for items in inventory as of February 29, 2004 for which customer sales orders have not yet been received. The inventory markdown reserve is calculated based on specific identification of aged goods and styles that are slow-moving or selling off-price.

Backlog

The Company had unfilled customer orders of \$8.8 million at February 29, 2004 compared to \$8.4 million at February 28, 2003, with such orders generally scheduled for delivery by August 2004 and August 2003, respectively. These amounts include both confirmed and unconfirmed orders that the Company believes, based on industry practice and past experience, will be confirmed. While cancellations, rejections and returns have generally not been material in the past, there can be no assurance that cancellations, rejections and returns will not reduce the amount of sales realized from the backlog of orders at February 29, 2004.

Increased orders in the Company's men's wear product line contributed to the increase in backlog of \$400,000, offset partially by a decrease in orders for the Company's sleepwear line. Because of the Company's reliance upon a few major accounts, any deteriorating financial performance by one or more of these customers could lead to the cancellation of existing orders and/or an inability to secure future orders, which would have a material adverse financial effect on the Company.

Impact of Exchange Rates

While the Company purchases over 90% of its products from foreign manufacturers, all of its purchases are denominated in United States dollars. Because the Company's products are sold primarily in the United States, in dollar denominated transactions, the Company does not engage in hedging or other arbitrage to reduce currency risk. An increase in the value of the dollar versus foreign currencies could enhance the Company's purchasing power for new purchase orders and reduce its cost of goods sold. Conversely, a decrease in the value of the dollar relative to foreign currencies could result in an increase in the Company's cost of manufacturing for new purchase orders and costs of goods sold.

Impact of Inflation and Deflation

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Management does not believe that inflation has had any material impact upon the Company's revenues or income from operations to date. Management believes that the apparel sector in which the Company operates has been in a period of deflation, contrary to the modest inflation experienced in the economy in general. The persistence of the consumer to buy "on sale" merchandise has put pressure on retail gross margins, which in turn has led to downward pressure from retailers on wholesale gross margins, in the form of selling cost adjustments taken as deductions against invoices issued by the Company. In the apparel industry, these are commonly referred to as markdown allowances or chargebacks. The company experienced a doubling of these allowances in fiscal 2003 to \$1.2 million, contributing to the operating loss incurred for that period. Without a corresponding decrease in fabric and labor prices, these markdown allowances have led to a decline in wholesale gross margins. Management believes these deflationary pressures will continue into the foreseeable future.

Future Operating Results

Business conditions in the apparel sector continue to be characterized by weak consumer demand and heavy discounting of merchandise by retailers. The continuing conflict in Iraq, coupled with the ongoing uncertainty of the overall economy has led most retailers to use significant discounting to encourage sales. In general, retailers have to sell more units in order to achieve sales equal to last year. The Company does not expect significant improvement in business conditions in the apparel sector for the remainder of the current calendar year. Given these uncertainties, the Company remains cautious and conservative regarding the remainder of fiscal 2004 and early fiscal 2005.

Item 4. Controls and Procedures

As of February 29, 2004, the Chief Executive and Financial Officer evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, he concluded that the disclosure controls and procedures of the Company are effective in timely alerting of the material information required to be included in the periodic filings with the Securities and Exchange Commission and that the information required to be disclosed in these filings is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Commission.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of this evaluation.

Cautionary Statement under the Private Securities Litigation Reform Act of 1995

Statements in the quarterly report on Form 10-Q under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations", as well as oral statements that may be made by the Company or by officers, directors or employees of the Company acting on the Company's behalf, that are not historical fact constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements involve known and unknown risks and uncertainties that may cause the Company's actual results in future periods to differ materially from forecasted results. Those risks include a softening of retailer or consumer acceptance of the Company's products, pricing pressures and other competitive forces, or unanticipated loss of a major customer. In addition, the Company's business, operations and financial condition are subject to reports and statements filed from time to time with the Securities and Exchange Commission.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There were no material legal proceedings to which the Company or any of its subsidiaries was a party in the six months ended February 29, 2004.

Item 6. Exhibits and Reports on Form 8-K

The Company filed a Current Report on Form 8-K on November 28, 2003, for its earnings press release dated November 28, 2003. Additionally, the Company filed a Current Report on Form 8-K on January 14, 2004, for its earnings press release dated January 14, 2004.

SIGNATURES

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

NITCHES, INC.

Registrant

April 14, 2004

By: /s/ Steven P. Wyandt

Steven P. Wyandt
As Principal Financial Officer and on
behalf of the Registrant

EXHIBIT INDEX

| Exhibit Number ----- | Exhibit ----- |
|----------------------------|--|
| 31 | Certification required under Section 302 |
| 32 | Certification required under Section 906 |