TARRANT APPAREL GROUP
Form 10-Q
November 14, 2006

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

OR

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.

FOR THE TRANSITION PERIOD FROM _____________ TO

COMMISSION FILE NUMBER: 0-26006

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

CALIFORNIA	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

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 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]

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

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FORM 10-Q
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PART I. FINANCIAL INFORMATION

CAUTIONARY LEGEND REGARDING FORWARD-LOOKING STATEMENTS

Some of the information in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. These forward-looking statements are subject to various risks and uncertainties. The forward-looking statements include, without limitation, statements regarding our future business plans and strategies and our future financial position or results of operations, as well as other statements that are not historical. You can find many of these statements by looking for words like "will", "may", "believes", "expects", "anticipates", "plans" and "estimates" and for similar expressions. Because forward-looking statements involve risks and uncertainties, there are many factors that could cause the actual results to differ materially from those expressed or implied. These include, but are not limited to, economic conditions. This Quarterly Report on Form 10-Q contains important cautionary statements and a discussion of many of the factors that could materially affect the accuracy of Tarrant's forward-looking statements and such statements and discussions are incorporated herein by reference. Any subsequent written or oral forward-looking statements made by us or any person acting on our behalf are qualified in their entirety by the cautionary statements and factors contained or referred to in this section. We do not intend or undertake any obligation to update any forward-looking statements to reflect events or circumstances after the date of this document or the date on which any subsequent forward-looking statement is made or to reflect the occurrence of unanticipated events.

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PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

TARRANT APPAREL GROUP
CONSOLIDATED BALANCE SHEETS

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

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

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

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTH SEPTEMB
	2006	2005	2006

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

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

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

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

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

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. ORGANIZATION AND BASIS OF CONSOLIDATION

The accompanying financial statements consist of the consolidation of Tarrant Apparel Group, a California corporation, and its majority owned subsidiaries located primarily in the U.S., Asia, Mexico, and Luxembourg. At September 30, 2006, we own 50.1% of United Apparel Ventures ("UAV") and 75% of PBG7, LLC ("PBG7"). We consolidate these entities and reflect the minority interests in earnings (losses) of the ventures in the accompanying financial statements. All inter-company amounts are eliminated in consolidation. The 49.9% minority interest in UAV is owned by Azteca Production International, a corporation owned by the brothers of our Chairman and Interim Chief Executive Officer, Gerard Guez. The 25% minority interest in PBG7 is owned by BH7, LLC, an unrelated party.

We serve specialty retail, mass merchandise and department store chains and major international brands by designing, merchandising, contracting for the manufacture of, and selling casual apparel for women, men and children under private label. Commencing in 1999, we expanded our operations from sourcing apparel to sourcing and operating our own vertically integrated manufacturing facilities. In August 2003, we determined to abandon our strategy of being both a trading and vertically integrated manufacturing company, and effective September 1, 2003, we leased and outsourced operation of our manufacturing facilities in Mexico to affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction. In August 2004, we entered into a purchase and sale agreement to sell these facilities to affiliates of Mr. Nacif, which transaction was consummated in the fourth quarter of 2004. See Note 14 of the "Notes to Consolidated Financial Statements".

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The consolidated financial data at December 31, 2005 is derived from audited financial statements which are included in our Annual Report on Form 10-K for the year ended December 31, 2005, and should be read in conjunction with the audited financial statements and notes thereto. Interim results are not necessarily indicative of results for the full year.

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

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates used by us in preparation of the consolidated financial statements include: (i) allowance for returns, discounts and bad debts, (ii) inventory, (iii) notes receivable - related parties reserve, (iv) valuation of long lived and intangible assets and goodwill, (v) income taxes, and (vi) stock options valuation. Actual results could differ from those estimates.

ROYALTY EXPENSES

Royalty expenses consist of the royalty payments and marketing fund commitments according to the various licensing agreements we have entered into. Royalty expenses are calculated based on certain percentage of net sales. Some of these agreements include minimum royalties. See Note 15 of the "Notes to Consolidated Financial Statements" regarding various agreements we have entered into.

DEFERRED RENT PROVISION

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

VALUATION OF DERIVATIVE INSTRUMENTS

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

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

STOCK-BASED COMPENSATION

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

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

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

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

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

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

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

On September 23, 2005, the Board of Directors approved the acceleration of vesting of all our unvested stock options, including those not issued under the plan; see Note 3 of the "Notes to Consolidated Financial Statements." In total, 1.7 million stock options with an average exercise price of $3.69 and an average remaining contractual life of 7.9 years were subject to this acceleration. The exercise prices and number of shares subject to the accelerated options were unchanged. The acceleration was effective as of September 23, 2005. As a result, there were no stock options granted prior to, but not yet vested as of January 1, 2006. There was no stock-based compensation expense related to employees or directors stock options recognized during the three months and nine months ended September 30, 2005.

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

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

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

3. STOCK-BASED COMPENSATION

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

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

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

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

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

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

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

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

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

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

4. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

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

5. INVENTORY

Inventory consists of the following:

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

6. EQUITY METHOD INVESTMENT - AMERICAN RAG

In the second quarter of 2003, we acquired a 45% equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores for $1.4 million, and our subsidiary, Private Brands, Inc., acquired a license to certain exclusive rights to this trademark. We have guaranteed the payment to the licensor of minimum royalties of $10.4 million over the initial 10-year term of the agreement. The guaranteed annual minimum royalty is payable in equal monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. The guaranteed annual minimum royalty for 2006 is $661,000. The minimum royalty paid and expensed for the three months and nine months ended September 30, 2006 was $165,000 and $496,000, respectively. At September 30, 2006, the total commitment on royalties remaining on the term was $8.6 million. Private Brands also entered into a multi-year exclusive distribution agreement with Macy's Merchandising Group, LLC ("MMG"), the sourcing arm of Federated Department Stores, to supply MMG with American Rag CIE, a casual sportswear collection for juniors and young men. Under this arrangement, Private Brands designs and manufactures American Rag apparel, which is distributed by MMG exclusively to Federated stores across the country. Beginning in August 2003, the American Rag collection was available in approximately 100 select Macy's locations, and is currently available in approximately 600 Macy's stores nationally. In June 2006, we signed a guarantee of certain liabilities of American Rag CIE to California United Bank to the aggregate amount equal at all times to the lesser of (A) 45% of the aggregate amount of the outstanding liabilities and (B) $675,000. Upon execution of the guarantee, we re-evaluated our investment under the provisions of FIN 46. In our analysis, we determined that consolidation under FIN 46 was still not appropriate. The investment in American Rag CIE, LLC totaling $2.2 million at September 30, 2006, is accounted for under the equity method and included in equity method investment on the accompanying consolidated balance sheets. Income from the equity method investment is recorded in the United States geographical segment. The change in investment in American Rag during the nine months ended September 30, 2006 was as follows:

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

TARRANT APPAREL GROUP

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7. NOTES RECEIVABLE - RELATED PARTY RESERVE

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

8. DEBT

Short-term bank borrowings consist of the following:

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

Long-term obligations consist of the following:

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

$ 10,968,328	$ 239,935

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

On June 13, 2002, we entered into a letter of credit facility of $25 million with UPS Capital Global Trade Finance Corporation ("UPS"). Under this facility, we could arrange for the issuance of letters of credit and acceptances. The facility was collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by us and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman and Interim Chief Executive Officer, also signed a guarantee of $5 million in favor of UPS to secure this facility. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. Additionally, Gerard Guez, our Chairman and Interim Chief Executive Officer, pledged to UPS 4.6 million shares of our common stock held by Mr. Guez to secure the obligations under the credit facility. On June 9, 2006, we completed the pay-off of all remaining amounts due under the letter of credit facility with UPS. As a result of the payment of these obligations, the letter of credit facility was terminated and all collateral released. There was no prepayment penalty under this arrangement. As of September 30, 2006, $0 was outstanding under this facility with UPS.

Since March 2003, DBS Bank (Hong Kong) Limited ("DBS") had made available a letter of credit facility of up to HKD 20 million (equivalent to US $2.6 million) to our subsidiaries in Hong Kong. This was a demand facility and

was secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman, and by our guarantee. The letter of credit facility was increased to HKD 30 million (equivalent to US $3.9 million) in June 2004. In October 2005, a tax loan for HKD 6.233 million (equivalent to US $804,000) was also made available to our Hong Kong subsidiaries and bears interest at the rate equal to the Hong Kong prime rate plus 1% and are subject to the same security. It bore interest at 9.25% per annum at September 30, 2006. As of September 30, 2006, $70,000 was outstanding under this tax loan.

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS. Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries may borrow under this facility at any time is US $25 million. The interest rate under the letter of credit facility is equal to the Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which the interest rate was 8.75% per annum at September 30, 2006, or the Standard Bills Rate quoted by DBS plus 0.5% if paid in any other currency, which the interest rate was 8.6% per annum at September 30, 2006. This is a demand facility and is secured by a security interest in all the assets of the Hong Kong subsidiaries, by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2006, interest coverage ratio, leverage ratio and limitations on additional indebtedness. As of September 30, 2006, $12.3 million was outstanding under this facility. In addition, $4.7 million of open letters of credit was outstanding and $8.0 million was available for future borrowings as of September 30, 2006.

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

From time to time, we open letters of credit under an uncommitted line of credit from Aurora Capital Associates which issues these letters of credits out of Israeli Discount Bank. As of September 30, 2006, $164,000 was outstanding under this facility (classified above under import trade bills payable) and $1.0 million of letters of credit were open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

LOAN FROM MAX AZRIA

On January 19, 2006, we borrowed $4.0 million from Max Azria pursuant to the terms of a promissory note, which amount bore interest at the rate of 5.5% per annum and was payable in weekly installments of $200,000 beginning on March 1, 2006. This was an unsecured loan. We paid off the remaining balance of this loan in July 2006. As of September 30, 2006, $0 was outstanding under this loan.

EQUIPMENT FINANCING

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

TERM LOAN - UPS

On December 31, 2004, our Hong Kong subsidiaries entered into a loan agreement with UPS pursuant to which UPS made a $5 million term loan, the proceeds of which were used to repay $5 million of indebtedness owed to UPS under the letter of credit of facility. The principal amount of this loan was due and payable in 24 equal monthly installments of approximately $208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. Under the amended loan agreement, we were subject to restrictive financial covenants of maintaining tangible net worth of $25 million at December 31, 2005

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and the last day of each fiscal quarter thereafter. There was also a provision capping maximum capital expenditure per quarter at $800,000. The obligations under the loan agreement were collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan was secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of $2,550,000 and $1,360,000 and a pledge by Gerard Guez, our Chairman and Interim Chief Executive Officer, of 4.6 million shares of our common stock. On June 9, 2006, we completed the pay-off of all remaining amounts due under the term loan agreement with UPS. As a result of the payment of these obligations, the term loan agreement was terminated and all collateral released. There was no prepayment penalty under this arrangement.

DEBT FACILITY AND FACTORING AGREEMENT - GMAC CF

On October 1, 2004, we amended and restated our previously existing credit facility with GMAC Commercial Finance Credit, LLC ("GMAC CF") by entering into a new factoring agreement with GMAC CF. The amended and restated agreement (the factoring agreement) extended the expiration date of the facility to September 30, 2007 and added as parties our subsidiaries Private Brands, Inc and No! Jeans, Inc. In addition, in connection with the factoring agreement, our indirect majority-owned subsidiary PBG7, LLC entered into a separate factoring agreement with GMAC CF. Pursuant to the terms of the factoring agreement, we and our subsidiaries agree to assign and sell to GMAC CF, as factor, all accounts which arise from our sale of merchandise or rendition of service created on a going forward basis. At our request, GMAC CF, in its discretion, may make advances to us up to the lesser of (a) up to 90% of our accounts on which GMAC CF has the risk of loss and (b) $40 million, minus in each case, any amount owed by us to GMAC CF. In May 2005, we amended our factoring agreement with GMAC CF to permit our subsidiaries party thereto and us, to borrow up to the lesser of $3 million or 50% of the value of eligible inventory. In connection with this amendment, we granted GMAC CF a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC CF to increase the amount we may borrow against inventory to the lesser of $5 million or 50% of the value of eligible inventory. The $5 million limit was reduced to $4 million on April 1, 2006.

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

CREDIT FACILITY FROM GUGGENHEIM CORPORATE FUNDING LLC AND WARRANTS

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

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

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

Durham Capital Corporation acted as our advisor in connection with the Guggenheim credit facility. As compensation for its services, we agreed to pay Durham Capital a cash fee in an amount equal to 1% of the committed principal amount of the loans under the Guggenheim credit facility. As a result, $250,000 was paid on June 16, 2006. In addition, we issued Durham Capital a warrant to purchase 77,143 shares of our common stock. This warrant has a term of 10 years and is exercisable at a price of $1.88 per share, subject to adjustment for certain dilutive issuances. 7,143 shares of this warrant will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at $105,000 using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. The $250,000 fee paid to Durham Capital and the value of the warrants to purchase 70,000 shares of our common stock of $105,000 is included in the deferred financing cost, and is amortized over the life of the loan. As of September 30, 2006, $23,000 was amortized.

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

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

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

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

9. CONVERTIBLE DEBENTURES AND WARRANTS

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

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

In June 2005, holders of our Debentures converted an aggregate of $2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of $820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of $2.00 per share. Debt discount of $248,000 related to the intrinsic value of the conversion option of $804,000 was expensed upon the conversion. Of the $620,000 financing cost paid to the placement agent, $191,000 was expensed upon the conversion. The intrinsic value of the conversion option, and the value of the warrant amortized in the first nine months of 2006 was $237,000. Total deferred financing cost amortized in the first nine months of 2006 was $95,000. Total interest paid to the holders of the Debentures in the first nine months of 2006 was $198,000. On June 26, 2006, we paid off the remaining balance of the outstanding Debentures of $6.9 million plus all accrued and unpaid interest and a prepayment penalty of $171,000. As a result of the repayment, the Debentures were terminated effective June 26, 2006. Upon paying off the Debentures, debt discount of $278,000 related to the intrinsic value of the conversion option of $804,000 was expensed, and of the $620,000 financing cost paid to the placement agent, $214,000 was expensed. The remaining value of the warrants to holders of our Debentures of $433,000 and warrants to the placement agent of $69,000 was also expensed.

10. EQUITY TRANSACTIONS

In March 2005, in connection with a settlement of a dispute involving a former employee named Nicolas Nunez, we agreed to compensate Mr. Nunez in the total amount of $875,000. In April 2005, we issued 195,313 shares of our common stock (having a value of $375,000) to Mr. Nunez pursuant to the terms of an agreement and plan of reorganization and paid Mr. Nunez $500,000 in settlement of all remaining claims by Mr. Nunez against us. In connection with this settlement, in March 2006, we cancelled 10,000 shares of our common stock previously issued to him.

11. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets" ("SFAS No. 156"), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity's exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity's fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. We are currently evaluating the impact of this Statement.

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

12. INCOME TAXES

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

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.

13. NET INCOME (LOSS) PER SHARE

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

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

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

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

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

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

14. RELATED PARTY TRANSACTIONS

As of September 30, 2006, related party affiliates were indebted to us in the amounts of $8.3 million. These include amounts due from Gerard Guez, our Chairman and Interim Chief Executive Officer. From time to time in the past, we borrowed funds from, and advanced funds to, Mr. Guez. The greatest outstanding balance of such advances to Mr. Guez in the third quarter of 2006 was approximately $2,234,000. At September 30, 2006, the entire balance due from Mr. Guez totaling $2.2 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All advances to Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was $129,000 and $165,000 for the nine months ended September 30, 2006 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately $226,000 and $321,000 for the nine months ended September 30, 2006 and 2005, respectively, which amounts were applied to reduce accrued interest and principal on Mr. Guez's loan. These amounts included fuel and related expenses incurred by 477 Aviation, LLC, a company owned by Mr. Guez, when our executives used this company's aircraft for business purposes. Since the enactment of the Sarbanes-Oxley Act in 2002, no further personal loans (or amendments to existing loans) have been or will be made to our executive officers or directors.

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

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

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

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, which agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates in October 2003, for an aggregate purchase price consisting of: a) $105,400 in cash and $3,910,000 by delivery of unsecured promissory notes bearing interest at 5.5% per annum; and b) $40,204,000, by delivery of secured promissory notes bearing interest at 4.5% per annum, maturing on December 31, 2005 and every year thereafter until December 31, 2014. The secured promissory notes are payable in partial or total amounts anytime prior to the maturity of each note. Included in the $41.0 million notes receivable - related party on the accompanying balance sheet as of September 30, 2006 was $1.3 million of Mexico value added taxes on the real property component of this transaction. Historically, we have placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we have satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, the purchasers have recently ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately $27.1 million, resulting in a notes receivable balance at September 30, 2006 of approximately $14 million. We will continue to pursue payments under the notes receivable and believe the remaining $14 million balance at September 30, 2006 is realizable. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, $5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased $0 and $4.1 million of fabric from Acabados y Terminados in the nine months ended September 30, 2006 and 2005, respectively. In addition to the above notes receivable, net amount due from these parties as of September 30, 2006 was $412,000, related to reimbursement expenses.

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

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

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

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

15. COMMITMENTS AND CONTINGENCIES

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

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

On October 17, 2004, Private Brands, Inc. entered into an agreement with J. S. Brand Management to design, manufacture and distribute Jessica Simpson branded jeans and casual apparel. This agreement has an initial three-year term, and provided we are in compliance with the terms of the agreement, is renewable for one additional two-year term. Minimum net sales are $20 million in year 1, $25 million in year 2 and $30 million in year 3. The agreement provides for payment of a sales royalty and advertising commitment at the rate of 8% and 3%, respectively, of net sales, for a total minimum payment obligation of $8.3 million over the initial term of the agreement. In December 2004, we advanced $2.2 million as payment for the first year's minimum royalties. We applied $1.1 million from the above advance against the royalty and marketing expenses in 2005 and $884,000 in the first three months of 2006. In March 2006, we had written off the capitalized balance of $192,000 and recognized a corresponding loss. The loss was classified as royalty expense on our consolidated statements of operations. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands. We are presently in litigation with the licensor. See Note 17 of the "Notes to Consolidated Financial Statements"

In the second quarter of 2003, we acquired a 45% equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores for $1.4 million, and our subsidiary, Private Brands, Inc., acquired a license to certain exclusive rights to this trademark. We have guaranteed the payment to the licensor of minimum royalties of $10.4 million over the initial 10-year term of the agreement. The guaranteed annual minimum royalty is payable in equal monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. At September 30, 2006, the total commitment on royalties remaining on the term was $8.6 million.

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif; a shareholder at the time of the transaction, with agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, $5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased $0 and $3.2 million of fabric under this agreement in the nine months ended September 30, 2006 and 2005, respectively.

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

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

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

TARRANT APPAREL GROUP

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

THREE MONTHS ENDED SEPTEMBER 30, 2005					
Sales	$ 69,023,000	$ 536,000	$ 7,000	$ --	$
Inter-company sales	--	43,576,000	--	--	(43,576
Total revenue	$ 69,023,000	$ 44,112,000	$ 7,000	$ --	$(43,576
Income (loss) from operations	$ 309,000	$ 2,568,000	$ 168,000	$ (34,000)	$
Interest income	$ 46,000	$ 525,000	$ --	$ 459,000	$ (524
Interest expense	$ 1,206,000	$ 95,000	$ --	$ 524,000	$ (524
Provision for depreciation and amortization	$ 462,000	$ 26,000	$ --	$ --	$
Capital expenditures	$ 186,000	$ 75,000	$ 112,000	$ --	$

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

17. LITIGATION

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

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

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

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

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

BUSINESS OVERVIEW AND RECENT DEVELOPMENTS

We are a design and sourcing company for private label and private brand casual apparel serving mass merchandisers, department stores, branded wholesalers and specialty chains located primarily in the United States. Our major customers include leading retailers, such as Kohl's, Chico's, Macy's Merchandising Group, Mervyn's, Mothers Work, Sears, Wal-Mart, Dillard's, Lane Bryant, Lerner New York, and the Avenue. Our products are manufactured in a variety of woven and knit fabrications and include jeans wear, casual pants, t-shirts, shorts, blouses, shirts and other tops, dresses and jackets. Our private brands include American Rag Cie and Alain Weiz.

PRIVATE LABEL

Private label business has been our core competency for over twenty years, and involves a one to one relationship with a large, centrally controlled retailer with whom we can develop product lines that fit with the characteristics of their particular customer. Private label net sales in the first nine months of 2006 were $135.8 million compared to $119.5 million in the first nine months of 2005.

The exposure of developing private brands collections has created new opportunities within the private label business to add value in the development and marketing of new initiatives for Sears, Mothers Work, Avenue, Chico's, and other retailers. These initiatives were launched during 2005, and are on track to be significant growth areas for 2006.

PRIVATE BRANDS

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

- AMERICAN RAG CIE: During the first quarter of 2005, we extended our agreement with Macy's Merchandising Group for nine years, pursuant to which we exclusively distribute our American Rag Cie brand through Macy's Merchandising Group's national Department Store organization of more than 600 stores. Net sales of American Rag Cie branded apparel totaled $23.1 million in the first nine months of 2006.

- ALAIN WEIZ: We continue to sell Alan Weiz apparel exclusively to Dillard's Department Stores. Net sales of Alain Weiz branded apparel totaled $4.6 million in the first nine months of 2006.

- SOUVENIR BY CYNTHIA ROWLEY: In July 2006, we terminated our License Agreements and the parent guaranty with Cynthia Rowley. In consideration of termination of the License Agreements, $400,000 was paid to Cynthia Rowley in July 2006.

- GEAR 7: During the fourth quarter of 2005, K-Mart discontinued sales of Gear 7 products, which resulted in a decline in sales for this brand in the fourth quarter of 2005. We do not anticipate sales of Gear 7 branded apparel in 2006.

- JESSICA SIMPSON brands: The JS by Jessica Simpson brand was originally launched as a denim line with Charming Shoppes. Net sales of JS by Jessica Simpson and Princy by Jessica Simpson, which is the department store and better specialty store brand, totaled $9.3 million in the first quarter of 2006. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands, and we are presently in litigation with this licensor. Accordingly, we did not have any sales of Jessica Simpson branded apparel after the first quarter of 2006 and do not anticipate any sales unless and until we are able to successfully resolve our dispute and retain our rights to these brands.

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

NOTES RECEIVABLE - RELATED PARTY RESERVE

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

CREDIT FACILITY REFINANCING

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

INTERNAL REVENUE SERVICE AUDIT

In January 2004, the Internal Revenue Service completed its examination of our Federal income tax returns for the years ended December 31, 1996 through 2001. The IRS has proposed adjustments to increase our income tax payable for the six years under examination. This adjustment would also result in additional state taxes and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately $6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. The proposed adjustments to our 2002 federal income tax return would not result in additional tax due for that year due to the tax loss reported in the 2002 federal return. However, it could reduce the amount of net operating losses available to offset taxes due from the preceding tax years. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and cash flow. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements under the caption "Income Taxes". The maximum amount of loss in excess of the amount accrued in the financial statements is $7.7 million. We do not believe that the adjustments, if any, arising

from the IRS examination, will result in an additional income tax liability beyond what is recorded in the accompanying consolidated balance sheets.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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