

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

TARRANT APPAREL GROUP
Form 10-Q
May 15, 2006

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 0-26006

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

CALIFORNIA
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated
filer, an accelerated filer or a non-accelerated filer. See definition of
"accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange
Act. Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

Number of shares of Common Stock of the Registrant outstanding as of May 12,
2006: 30,543,763.

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

TARRANT APPAREL GROUP FORM 10-Q INDEX

PART I. FINANCIAL INFORMATION

	PAGE

Item 1. Financial Statements	
Consolidated Balance Sheets at March 31, 2006 (unaudited) and December 31, 2005 (audited).....	2
Consolidated Statements of Operations for the Three Months Ended March 31, 2006 and March 31, 2005 (unaudited).....	3
Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2006 and March 31, 2005 (unaudited).....	4
Notes to Consolidated Financial Statements (unaudited).....	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3. Quantitative and Qualitative Disclosures About Market Risk .	31
Item 4. Controls and Procedures.....	31

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.....	32
Item 1A. Risk Factors.....	32
Item 6. Exhibits.....	38
SIGNATURES.....	39

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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.

1

PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

TARRANT APPAREL GROUP CONSOLIDATED BALANCE SHEETS

	MARCH 31, 2006	DECEMBER 31, 2005
	----- (unaudited)	----- (audited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 500,636	\$ 1,641,768
Accounts receivable, net	62,370,128	54,598,443
Due from related parties	3,359,888	3,100,928
Inventory	21,836,090	31,628,960
Current portion of notes receivable -- related parties	5,139,387	5,139,387
Prepaid expenses	1,264,688	1,292,441
Prepaid royalties	--	1,123,531
Income taxes receivable	25,468	25,468
	-----	-----
Total current assets	94,496,285	98,550,926
Property and equipment, net of \$10.9 million and \$10.8 million accumulated depreciation at March 31, 2006 and December 31, 2005, respectively	1,587,822	1,702,840
Notes receivable - related parties, net of current portion	35,834,002	36,268,446
Due from related parties	3,004,352	2,994,945
Equity method investment	2,186,278	2,138,865
Deferred financing cost, net of \$823,097 and \$711,250 accumulated amortization at March 31, 2006 and December 31, 2005, respectively	726,939	838,786
Other assets	258,062	164,564
Goodwill	8,582,845	8,582,845
	-----	-----
Total assets	\$ 146,676,585	\$ 151,242,217
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term bank borrowings	\$ 12,479,989	\$ 13,833,532
Accounts payable	25,888,506	33,278,959
Accrued expenses	9,564,188	9,503,806
Income taxes	16,795,605	16,828,538
Current portion of long-term obligations and factoring arrangement	39,540,629	36,109,699

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Total current liabilities	104,268,917	109,554,534
Long-term obligations	14,774	239,935
Convertible debentures, net	6,083,539	5,965,098
Deferred tax liabilities	25,403	47,098
Minority interest	63,747	75,241
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized; no shares at March 31, 2006 and December 31, 2005 issued and outstanding	--	--
Common stock, no par value, 100,000,000 shares authorized; 30,543,763 shares at March 31, 2006 and 30,553,763 shares at December 31, 2005 issued and outstanding	114,977,465	114,977,465
Warrant to purchase common stock	2,846,833	2,846,833
Contributed capital	10,004,331	10,004,331
Accumulated deficit	(89,353,243)	(90,189,615)
Notes receivable from officer/shareholder	(2,255,181)	(2,278,703)
Total shareholders' equity	36,220,205	35,360,311
Total liabilities and shareholders' equity	\$ 146,676,585	\$ 151,242,217
	=====	=====

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

2

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Net sales	\$ 61,261,243	\$ 44,830,291
Cost of sales	48,742,481	35,884,573
Gross profit	12,518,762	8,945,718
Selling and distribution expenses	2,929,690	2,561,854
General and administrative expenses	6,460,143	5,855,823
Royalty expenses	1,482,945	294,765
Income from operations	1,645,984	233,276
Interest expense	(1,188,056)	(813,185)

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Interest income	485,343	553,223
Interest in income of equity method investee ...	47,413	163,311
Other income	33,806	64,557
Other expense	--	(5,839)
Minority interest	11,494	--
	-----	-----
Income before provision for income taxes	1,035,984	195,343
Provision for income taxes	199,612	301,163
	-----	-----
Net income (loss)	\$ 836,372	\$ (105,820)
	=====	=====
Net income (loss) per share - Basic	\$ 0.03	\$ (0.00)
Net income (loss) per share -- Diluted	\$ 0.03	\$ (0.00)
	=====	=====
Weighted average common and common equivalent shares outstanding:		
Basic	30,551,207	28,814,763
Diluted	30,551,207	28,814,763
	=====	=====

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

3

TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
	-----	-----
Operating activities:		
Net income (loss)	\$ 836,372	\$ (105,820)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Deferred taxes	(21,695)	(52,011)
Depreciation and amortization	372,738	568,165
Provision for returns and discounts	155,978	254,040
Gain on sale of fixed assets	(1,283)	(849)
Interest in income of equity method investee	(47,413)	(163,311)
Minority interest	(11,494)	--
Changes in operating assets and liabilities:		
Accounts receivable	(7,927,663)	(5,777,964)
Due to/from related parties	(268,367)	1,237,215
Inventory	9,792,870	866,125
Prepaid expenses	1,151,283	(1,120,844)
Accounts payable	(7,390,453)	(5,867,978)

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Accrued expenses and income tax payable	27,449	586,759
	-----	-----
Net cash used in operating activities	(3,331,678)	(9,576,473)
Investing activities:		
Purchase of fixed assets	(22,447)	(77,018)
Proceeds from sale of fixed assets	2,800	6,387
Collection on notes receivable, related parties	434,444	217,222
Collection of advances from shareholders/officers ..	23,522	2,334,053
	-----	-----
Net cash provided by investing activities	438,319	2,480,644
Financing activities:		
Short-term bank borrowings, net	1,652,736	(5,292,126)
Proceeds from long-term obligations	51,911,927	50,602,423
Payment of long-term obligations and bank borrowings	(51,812,436)	(39,228,376)
	-----	-----
Net cash provided by financing activities	1,752,227	6,081,921
	-----	-----
Decrease in cash and cash equivalents	(1,141,132)	(1,013,908)
Cash and cash equivalents at beginning of period	1,641,768	1,214,944
	-----	-----
Cash and cash equivalents at end of period	\$ 500,636	\$ 201,036
	=====	=====

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

4

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 March 31, 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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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 13 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)

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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

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. All of these agreements include minimum royalties. See Note 14 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 March 31, 2006, deferred rent of \$25,000 was recorded under accrued expense in our consolidated financial statements.

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 its 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 three months ended March 31, 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).

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2005: weighted-average volatility factors of the expected market price of our common stock of 0.55 for the three months ended March 31, 2005, weighted-average risk-free interest rates of 4% for the three months ended March 31, 2005, dividend yield of 0% and weighted-average expected life of the options of 4 years. These pro forma results may not be indicative of the future results for the full fiscal year due to potential grants, vesting and other factors.

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

ended March 31, 2005:

6

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

	THREE MONTHS ENDED MARCH 31, 2005

Net loss as reported	\$ (105,820)
Add stock-based employee compensation charges reported in net loss	--
Pro forma compensation expense, net of tax	(76,509)

Pro forma net loss	\$ (182,329)
	=====
Net loss per share as reported - Basic and Diluted	\$ (0.00)
Add stock-based employee compensation charges reported in net loss - Basic and Diluted	--
Pro forma compensation expense per share - Basic and Diluted	(0.00)

Pro forma loss per share - Basic and Diluted	\$ (0.00)
	=====

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 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.

We did not have any option granted during the first quarter of 2006. On September 23, 2005, the Board of Directors approved the acceleration of vesting of all our unvested stock options. In total, 1.7 million stock options with an average exercise price of \$3.69 and an average remaining contractual life of 7.9 years were subject to this acceleration. The exercise prices and number of shares subject to the accelerated options were unchanged. The acceleration was effective as of September 23, 2005. As a result, there was not any 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 ended March 31, 2006 and 2005.

Certain 2005 amounts have been reclassified to conform to the 2006

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

presentation.

3. STOCK BASED COMPENSATION

Our Employee Incentive Plan, formerly the 1995 Stock Option Plan, as amended and restated in May 1999 (the Plan), has authorized the grant of both incentive and non-qualified stock options to officers, employees, directors and consultants of the Company for up to 5,100,000 shares (as adjusted for a stock split effective May 1998) of our common stock. The exercise price of incentive options must be equal to 100% of fair market value of common stock on the date of grant and the exercise price of non-qualified options must not be less than the par value of a share of common stock on the date of grant. The Plan was also amended to expand the types of awards, which may be granted pursuant thereto to include stock appreciation rights, restricted stock and other performance-based benefits. At March 31, 2006, no further options may be granted under the Plan.

In October 1998, we granted 1,000,000 non-qualified stock options not under the Plan. The options were granted to our Chairman and Vice Chairman at \$13.50 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2008 and vest over four years. In May 2002, we granted 3,000,000 non-qualified stock options not under the Plan. The options were granted to our Chairman, Vice Chairman and Mr. Kamel Nacif at \$5.50 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2012 and vest over three years. The 1,000,000 stock options granted to Kamel Nacif were forfeited in 2005. In May 2003, we granted 2,000,000 non-qualified stock options not under the Plan to our Chairman and Vice Chairman. The options were granted at \$3.65 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2013 and vest over four years. In December 2003, we granted 400,000 non-qualified stock options not under the Plan to our President. The options were

7

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

granted at \$3.94 per share, the closing sales price of the common stock on the day of the grant. The options expire in 2013 and vest over four years.

A summary of our stock option activity, and related information for the year ended December 31, 2005 and the three months ended March 31, 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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Options outstanding at December 31, 2005	6,733,050	\$1.39-\$45.50
Granted	--	--
Exercised	--	--
Forfeited	(200)	\$ 3.60
Expired	--	--
	-----	-----
Options outstanding at March 31, 2006	6,732,850	\$1.39-\$45.50

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

The following table summarizes information about stock options outstanding as of December 31, 2005 and March 31, 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 - Exercisable	6,733,050	\$ 6.25	6.0	\$ 12,440
As of March 31, 2006:				
Employees - Outstanding	6,732,850	\$ 6.25	5.7	\$ 0
Employees - Exercisable	6,732,850	\$ 6.25	5.7	\$ 0

4. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	MARCH 31, 2006	DECEMBER 31, 2005
	-----	-----
U.S. trade accounts receivable	\$ 11,008,456	\$ 2,893,217
Foreign trade accounts receivable	18,142,370	19,619,172
Factored accounts receivable	33,877,827	33,222,354
Other receivables	2,449,203	1,815,450
Allowance for returns, discounts and bad debts .	(3,107,728)	(2,951,750)
	-----	-----
	\$ 62,370,128	\$ 54,598,443
	=====	=====

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

5. INVENTORY

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Inventory consists of the following:

	MARCH 31, 2006	DECEMBER 31, 2005
Raw materials - fabric and trim accessories	\$ 3,824,852	\$ 5,079,428
Finished goods shipments-in-transit	7,262,727	8,800,014
Finished goods	10,748,511	17,749,518
	-----	-----
	\$21,836,090	\$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, are 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 minimum royalty paid and expensed for the three month ended March 31, 2006 was \$165,000. At March 31, 2006, the total commitment on royalties remaining on the term was \$8.9 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, the Bon Marche, Burdines, Goldsmith's, Lazarus and Rich's-Macy's locations. The investment in American Rag CIE, LLC totaling \$2.2 million at March 31, 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 three month ended March 31, 2006 was as follows:

Balance as of December 31, 2005	\$ 2,138,865
Share of income	47,413
Distribution	(0)

Balance as of March 31, 2006	\$ 2,186,278
	=====

7. DEBT

Short-term bank borrowings consist of the following:

	MARCH 31, 2006	DECEMBER 31, 2005
Import trade bills payable - UPS, DBS Bank and Aurora Capital	\$ 4,857,531	\$ 4,165,306
Bank direct acceptances - UPS and		

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

DBS Bank	1,368,219	1,471,476
Other Hong Kong credit facilities -		
UPS and DBS Bank	6,254,239	8,196,750
	-----	-----
	\$12,479,989	\$13,833,532
	=====	=====

9

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Long-term obligations consist of the following:

	MARCH 31, 2006	DECEMBER 31, 2005
	-----	-----
Loan from Max Azria	\$ 3,006,279	\$ --
Equipment financing	34,725	83,206
Term loan - UPS	2,083,333	2,708,333
Debt facility - GMAC CF	34,431,066	33,558,095
	-----	-----
	39,555,403	36,349,634
Less current portion	(39,540,629)	(36,109,699)
	-----	-----
	\$ 14,774	\$ 239,935
	=====	=====

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

On June 13, 2002, we entered into a letter of credit facility of \$25 million with UPS Capital Global Trade Finance Corporation ("UPS"). Under this facility, we may arrange for the issuance of letters of credit and acceptances. The facility is collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by Tarrant Apparel Group and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman and Interim Chief Executive Officer, also signed a guarantee of \$5 million in favor of UPS to secure this facility. This facility bore interest at 10.75% per annum at March 31, 2006. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. On June 27, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from June 30, 2005 to August 31, 2005 and to reduce the tangible net worth requirement at June 30, 2005. On August 31, 2005, we amended the letter of credit facility with UPS to further extend the expiration date of the facility to October 31, 2005, immediately reduce the maximum amount of borrowings to \$14.5 million on September 1, 2005 and further reduced the maximum amount of borrowing to \$14.0 million on October 1, 2005. On October 31, 2005, we further amended the letter of credit facility with UPS to extend the expiration date of the facility to January 31, 2006 and amend the interest rate to "prime rate" plus 3%. The facility amendment also provided for reduction in the maximum amount of borrowings to \$13.5 million commencing on November 1, 2005, to \$13.0 million commencing on December 1, 2005, and to \$12.5 million commencing on January 1, 2006. Additionally, Gerard Guez, our Chairman

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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 January 27, 2006, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from January 31, 2006 to July 31, 2006. The amendment provides for reduction of the maximum amount of borrowings under the facility to \$12.0 million commencing on April 1, 2006, \$11.5 million commencing on May 1, 2006, \$11.0 million commencing on June 1, 2006 and to \$10.5 million commencing on July 1, 2006. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of \$25 million as of December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of \$800,000. As of March 31, 2006, we were in compliance with the covenants. As of March 31, 2006, \$8.0 million was outstanding under this facility with UPS (classified above as follows: \$1.8 million in import trade bills payable; \$1.4 million in bank direct acceptances and \$4.8 million in other Hong Kong credit facilities) and an additional \$2.5 million was available for future borrowings. In addition, \$2.0 million of open letters of credit was outstanding as of March 31, 2006.

Since March 2003, DBS Bank (Hong Kong) Limited (formerly known as Dao Heng Bank) has made available a letter of credit facility of up to HKD 20 million (equivalent to US \$2.6 million) to our subsidiaries in Hong Kong. This is a demand facility and is secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and 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. As of March 31, 2006, \$2.5 million was outstanding under this facility. In addition, \$1.1 million of open letters of credit was outstanding and \$294,000 was available for future borrowings as of March 31, 2006. In October 2005, a tax loan for HKD 6.233 million (equivalent to US \$804,000) was also made available to our Hong Kong subsidiaries. As of March 31, 2006, \$478,000 was outstanding under this tax loan.

As of March 31, 2006, the total balance outstanding under the DBS Bank credit facilities was \$3.0 million (classified above as follows: \$1.6 million in import trade bills payable, \$0 in bank direct acceptances and \$1.4 million in other Hong Kong credit facilities).

10

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 March 31, 2006, \$1.5 million was outstanding under this facility (classified above under import trade bills payable) and \$3.2 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 bears interest at the rate of 5.5% per annum and is payable in weekly installments of \$200,000 beginning on

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

March 1, 2006. This is an unsecured loan. As of March 31, 2006, \$3.0 million 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. As of March 31, 2006, \$35,000 was outstanding under the two 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 is due and payable in 24 equal monthly installments of approximately \$208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. This facility bore interest at 9.75% per annum at March 31, 2006. On June 27, 2005, we amended the loan agreement with UPS to reduce the tangible net worth requirement at June 30, 2005. Under the amended loan agreement, we are subject to restrictive financial covenants of maintaining tangible net worth of \$25 million at December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditure per quarter at \$800,000. As of March 31, 2006, we were in compliance with the covenants. As of March 31, 2006, \$2.1 million was outstanding. The obligations under the loan agreement are collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan is secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of \$2,550,000 and \$1,360,000 and a pledge by Gerard Guez, our Chairman and Interim Chief Executive Officer, of 4.6 million shares of our common stock.

DEBT FACILITY AND FACTORING AGREEMENT - GMAC CF

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

On October 1, 2004, we amended and restated the Debt Facility with 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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

each case, any amount owed by us to GMAC CF. Pursuant to the terms of the PBG7 factoring agreement, PBG7 agreed to assign and sell to GMAC CF, as factor, all accounts, which arise from PBG7's sale of merchandise or

11

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

rendition of services created on a going-forward basis. At PBG7's request, GMAC CF, in its discretion, may make advances to PBG7 up to the lesser of (a) up to 90% of PBG7's accounts on which GMAC CF has the risk of loss, and (b) \$5 million minus in each case, any amounts owed to GMAC CF by PBG7. The facility bore interest at 7.8256% per annum and the facility under PBG7, LLC bore interest at 8.25% per annum, respectively, at March 31, 2006. Restrictive covenants under the revised facility include a limit on quarterly capital expenses of \$800,000 and tangible net worth of \$25 million at December 31, 2005 and at the end of each fiscal quarter thereafter. As of March 31, 2006, we were in compliance with the covenants. A total of \$29.9 million was outstanding with respect to receivables factored under the GMAC CF facility at March 31, 2006.

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 will be reduced to \$4 million on April 1, 2006 and will be further reduced to \$3 million on July 1, 2006. The maximum borrowing availability under the factoring agreement, based on the borrowing base formula remains at \$40 million. A total of \$4.5 million was outstanding under the GMAC CF facility at March 31, 2006 with respect to collateralized inventory.

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

8. 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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

default and permit the holder thereof to accelerate the maturity if the full principal amount together with interest and other amounts owing upon the occurrence of such events of default. The Debentures are secured by a subordinated lien on certain of our accounts receivable and related assets. The closing market price of our common stock on the closing date of the financing was \$1.96. The convertible debenture was thus valued at \$8,996,000, resulting in an effective conversion price of \$1.799 per share. The intrinsic value of the conversion option of \$804,000 is being amortized over the life of the loan. The value of the warrants of \$866,000 and the intrinsic value of the conversion option of \$804,000 were netted from the \$10 million presented as the convertible debentures, net on our accompanying balance sheets at December 31, 2004.

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

In June 2005, holders of our Debentures converted an aggregate of \$2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of \$820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of \$2.00 per share. Debt discount of \$248,000 related to the intrinsic value of the conversion option of \$804,000 was expensed upon the conversion. Of the \$620,000 financing cost paid to the placement agent, \$191,000 was expensed upon the conversion. The intrinsic value of the

12

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

conversion option, and the value of the warrant amortized in the first three months of 2006 was \$118,000. Total deferred financing cost amortized in the first three months of 2006 was \$47,000. Total interest paid to the holders of the Debentures in the first three months of 2006 was \$104,000. As of March 31, 2006, \$6.1 million, net of \$829,000 of debt discount, remained outstanding under the Debentures.

9. EQUITY TRANSACTIONS

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

10. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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.

11. INCOME TAXES

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

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

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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.

12. NET INCOME (LOSS) PER SHARE

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

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Basic EPS Computation:		
Numerator	\$ 836,372	\$ (105,820)
Denominator:		
Weighted average common shares outstanding	30,551,207	28,814,763
Basic EPS	\$ 0.03	\$ (0.00)
	=====	=====
Diluted EPS Computation:		
Numerator	\$ 836,372	\$ (105,820)
Denominator:		
Weighted average common shares outstanding	30,551,207	28,814,763
Incremental shares from assumed exercise of warrants	--	--
convertible debentures	--	--
options	--	--
Total shares	30,551,207	28,814,763
Diluted EPS	\$ 0.03	\$ (0.00)
	=====	=====

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

No shares of outstanding options and warrants were included in the computation of income per share in the three months ended March 31, 2006 and 2005 as the exercise prices of the remaining shares were greater than the average market price for the three months ended March 31, 2006 and 2005. All options, warrants and convertible debentures were excluded from the computation of net income (loss) per share in the three months ended March 31, 2006 and 2005, as the impact would be anti-dilutive. The effect of applying "IF Converted Method" to the convertible debenture was anti-dilutive; therefore, it was excluded from the computation of income per share in the three months ended March 31, 2006 and 2005. The following table presents outstanding options, warrants and convertible debentures.

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

	AS OF MARCH 31,	
	2006	2005
Options	6,732,850	6,994,787
Warrants	2,361,732	2,361,732
Convertible debentures	3,456,313	5,000,000
Total	12,550,895	14,356,519
	=====	=====

13. RELATED PARTY TRANSACTIONS

As of March 31, 2006, related party affiliates were indebted to us in the amounts of \$8.6 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 first quarter of 2006 was approximately \$2,279,000. At March 31, 2006, the entire balance due from Mr. Guez totaling

14

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

\$2.3 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All advances to, and borrowings from, Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$44,000 and \$74,000 for the three months ended March 31, 2006 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately \$67,000 and \$108,000 for the three months ended March 31, 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 ("UAV"). This entity was created to coordinate the production of apparel for a single customer of our branded business. UAV is owned 50.1% by Tag Mex, Inc., our wholly owned subsidiary, and 49.9% by Azteca. Results of the operation of UAV have been consolidated into our results since July 2001 with the minority partner's share of gain and losses eliminated through the minority interest line in our financial statements. Due to the restructuring of our Mexico operations, we discontinued manufacturing for UAV customers in the second quarter of 2004. UAV made purchases from two related parties in Mexico, an affiliate of Azteca and Tag-It Pacific, Inc.

At March 31, 2006, Messrs. Guez and Kay beneficially owned 590,000 and

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc. ("Tag-It"), collectively representing approximately 8.7% of Tag-It Pacific's common stock. Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Starting from 1998, Tag-It assumed the responsibility for managing and sourcing all trim and packaging used in connection with products manufactured by or on behalf of us in Mexico. Due to the restructuring of our Mexico operations, Tag-It no longer manages our trim and packaging requirements. We purchased \$97,000 and \$0 of trim inventory from Tag-It in the three months ended March 31, 2006 and 2005, respectively. We purchased \$0 and \$135,000 of finished goods and service from Azteca and its affiliates in the three months ended March 31, 2006 and 2005, respectively. Our total sales of fabric and service to Azteca in the three months ended March 31, 2006 and 2005 were \$9,000 and \$63,000, respectively. Pursuant to the operating agreement for UAV, two and one half percent of gross sales of UAV were paid to each of the members of UAV as management fees. Net amount due from these related parties as of March 31, 2006 was \$5.6 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, 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 March 31, 2006 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, \$5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased \$0 and \$840,000 of fabric from Acabados y Terminados in the three months ended March 31, 2006 and 2005, respectively. Net amount due from these parties as of March 31, 2006 was \$507,000.

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 \$269,000 and \$255,000 in rent in the three months ended March 31, 2006 and 2005, respectively, for office and warehouse facilities. Our Los Angeles offices and warehouse is leased on a month to month basis. On January 1, 2006, we renewed our lease agreement with Lynx International Limited for our office space in Hong Kong for one year.

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

At March 31, 2006, we had various employee receivables totaling \$273,000 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.

14. 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 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.

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, are 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 March 31, 2006, the total commitment on royalties remaining on the term was \$8.9 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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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 \$840,000 of fabric in the three months ended March 31, 2006 and 2005, respectively.

16

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

15. OPERATIONS BY GEOGRAPHIC AREAS

Our predominant business is the design, distribution and importation of private label and private brand casual apparel. Substantially all of our revenues are from the sales of apparel. We are organized into 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 -----
THREE MONTHS ENDED MARCH 31, 2006				
Sales	\$ 60,570,000	\$ 681,000	\$ 10,000	\$ --
Inter-company sales	--	29,351,000	--	--
	-----	-----	-----	-----
Total revenue	\$ 60,570,000	\$ 30,032,000	\$ 10,000	\$ --
	=====	=====	=====	=====
 Income (loss) from operations ...	 \$ 571,000	 \$ 1,164,000	 \$ (87,000)	 \$ (2,000)
	=====	=====	=====	=====
Interest income	\$ 44,000	\$ 657,000	\$ --	\$ 441,000
	=====	=====	=====	=====
Interest expense	\$ 1,127,000	\$ 58,000	\$ 3,000	\$ 657,000
	=====	=====	=====	=====
Provision for depreciation and amortization	\$ 346,000	\$ 27,000	\$ --	\$ --
	=====	=====	=====	=====
Capital expenditures	\$ 9,000	\$ 13,000	\$ --	\$ --
	=====	=====	=====	=====
 Total assets	 \$ 111,857,000	 \$ 120,898,000	 \$ 14,691,000	 \$ 211,801,000
	=====	=====	=====	=====

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

THREE MONTHS ENDED MARCH 31, 2005

Sales	\$ 44,600,000	\$ 224,000	\$ 6,000	\$ --
Inter-company sales	--	26,835,000	--	--
	-----	-----	-----	-----
Total revenue	\$ 44,600,000	\$ 27,059,000	\$ 6,000	\$ --
	=====	=====	=====	=====
Income (loss) from operations ...	\$ (696,000)	\$ 1,133,000	\$ (204,000)	\$ --
	=====	=====	=====	=====
Interest income	\$ 75,000	\$ 374,000	\$ --	\$ 478,000
	=====	=====	=====	=====
Interest expense	\$ 789,000	\$ 24,000	\$ --	\$ 374,000
	=====	=====	=====	=====
Provision for depreciation and amortization	\$ 473,000	\$ 24,000	\$ 71,000	\$ --
	=====	=====	=====	=====
Capital expenditures	\$ 47,000	\$ 24,000	\$ --	\$ --
	=====	=====	=====	=====
Total assets	\$ 104,742,000	\$ 113,199,000	\$ 27,969,000	\$ 212,269,000
	=====	=====	=====	=====

17

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

16. LITIGATION

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands 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. The 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, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto, 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. On or about April 26, 2006, Camuto 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. On or about April 17, 2006, Ms. Simpson served a motion seeking dismissal of the cause of action asserted against her. We intend to vigorously defend Camuto's counterclaim and vigorously oppose Ms. Simpson's motion.

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

enrichment. This case is currently pending in the United States District Court for the Southern District of New York and is scheduled for trial on December 18, 2006. We will continue to vigorously defend against the breach of contract and unjust enrichment claim.

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.

17. SUBSEQUENT EVENTS

On May 12, 2006, we entered into a commitment letter with Guggenheim Corporate Funding, LLC with respect to a \$65 million credit facility. The commitment letter contemplates that the credit facility will consist of an initial term loan of \$30 million, which will be used to repay certain existing indebtedness and fund our general operating and working capital needs, and a second term loan of \$35 million to be used, if at all, to finance acquisitions acceptable to Guggenheim. The credit facility would be secured by all or substantially all of our consolidated assets. Completion of the financing is subject to customary conditions precedent, including, without limitation, the preparation and execution of definitive loan documents, Guggenheim's completion and satisfaction with its legal due diligence review of us, obtaining all necessary consents and other third party approvals, and the preparation and execution of an inter-creditor agreement between the lenders and our other lenders.

We are also in negotiations with GMAC CF, UPS and DBS concerning our credit facilities in effect with these lenders.

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.

18

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, the Avenue, and J.C. Penney. 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, No! Jeans, Alain Weiz, Gear 7, Souvenir by Cynthia Rowley and brands associated with Jessica Simpson, which include "JS by Jessica Simpson", "Princy by Jessica Simpson" and "Sweet Kisses by Jessica Simpson".

PRIVATE LABEL

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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 sales in the first quarter of 2006 were \$42.1 million compared to \$33.5 million in the first quarter of 2005.

The success of our private brands collections has created new opportunities within the private label business to add value in the development and marketing of new initiatives for Sears, Mothers Work, Avenue, Chico's, and other retailers. These initiatives were launched during 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 sales in the first quarter of 2006 were \$19.2 million compared to \$11.3 million in the first quarter of 2005. At March 31, 2006, we owned or licensed rights to the following private brands:

- o AMERICAN RAG CIE: During the first quarter of 2005, we extended our agreement with Macy's Merchandising Group for six years, pursuant to which we exclusively distribute our American Rag Cie brand through Macy's Merchandising Group's national Department Store organization of more than 500 stores. Net sales of American Rag Cie branded apparel totaled \$5.3 million in the first quarter of 2006.
- o ALAIN WEIZ: We continue to sell Alan Weiz apparel exclusively to Dillard's Department Stores. Net sales of Alain Weiz branded apparel totaled \$2.0 million in the first quarter of 2006.
- o SOUVENIR BY CYNTHIA ROWLEY: We are in discussions with retailers to identify a potential distribution alliance for the 2006 fall or holiday season for Souvenir by Cynthia Rowley.
- o GEAR 7: During the fourth quarter of 2005, K-Mart discontinued sales of Gear 7 products, which resulted in a decline in sales for this brand in the fourth quarter of 2005. We do not anticipate sales of Gear 7 branded apparel in 2006.
- o JESSICA SIMPSON brands: The JS by Jessica Simpson brand was originally launched as a denim line with Charming Shoppes. Net sales of JS by Jessica Simpson and Princy by Jessica Simpson, which is the department store and better specialty store brand, totaled \$9.7 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 do not

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

first quarter of 2006 unless and until we are able to successfully resolve our dispute and retain our rights to these brands.

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

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 assets and liabilities. We are required to make assumptions about matters, which are highly uncertain at the time of the estimate. Different estimates we could reasonably have used or changes in the estimates that are reasonably likely to occur could have a material effect on our financial condition or result of operations. Estimates and assumptions about future events and their effects cannot be determined with certainty. On an ongoing basis, we evaluate estimates, including those related to returns, discounts, bad debts, inventories, intangible assets, income taxes, and contingencies and litigation. We base our estimates on historical experience and on various assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

and as our operating environment changes. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged period of time.

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

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For a further discussion on the application of these and other accounting policies, see Note 1 of the "Notes to Consolidated Financial Statements" included in our Annual Report on Form 10-K for the year ended December 31, 2005.

20

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

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

As of March 31, 2006, the balance in the allowance for returns, discounts and bad debts reserves was \$3.1 million.

INVENTORY

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

VALUATION OF LONG-LIVED AND INTANGIBLE ASSETS AND GOODWILL

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

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets." According to this statement, goodwill and other intangible assets with indefinite lives are no longer subject to amortization, but rather an assessment of impairment applied on a fair-value-based test on an annual basis or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

We utilized the discounted cash flow methodology to estimate fair value. As of March 31, 2006, we have a goodwill balance of \$8.6 million, and a net property and equipment balance of \$1.6 million.

INCOME TAXES

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

In addition, accruals are also estimated for ongoing audits regarding U.S. Federal tax issues that are currently unresolved, based on our estimate of whether, and the extent to which, additional taxes will be due. We

21

routinely monitor the potential impact of these situations and believe that amounts are properly accrued for. If we ultimately determine that payment of these amounts is unnecessary, we will reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We will record an additional charge in our provision for taxes in any period we determine that the original estimate of a tax liability is less than we expect the ultimate assessment to be. See Note 11 of the "Notes to Consolidated Financial Statements" for a discussion of current tax matters.

DEBT COVENANTS

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

by curtailing operations, and to raise capital through the sale of assets, issuance of equity or otherwise, any of which could have a material adverse effect on our financial condition and results of operations.

NEW ACCOUNTING PRONOUNCEMENTS

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

RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Net sales	100.0%	100.0%
Cost of sales	79.6	80.0
Gross profit	20.4	20.0
Selling and distribution expenses	4.8	5.7
General and administration expenses	10.5	13.1
Royalty expenses	2.4	0.6
Income from operations	2.7	0.6
Interest expense	(1.9)	(1.8)
Interest income	0.8	1.2
Interest in income of equity method investee	0.1	0.4
Other income	0.0	0.1
Other expense	(0.0)	(0.0)
Minority interest	0.0	0.0
Income before taxes	1.7	0.5
Income taxes	0.3	0.7
Net income (loss)	1.4%	(0.2)%

FIRST QUARTER 2006 COMPARED TO FIRST QUARTER 2005

Net sales increased by \$16.4 million, or 36.7%, to \$61.3 million in first quarter of 2006 from \$44.8 million in the first quarter of 2005. Sales of private label in the first quarter of 2006 were \$42.1 million compared to \$33.5 million in the same period of 2005, with the increase resulting primarily from increased sales to Chico's, Mervyn's, Mothers Work and Macy's Merchandising Group. Sales of private brands in the first quarter of 2006 were \$19.2

million compared to \$11.3 million in the same period of 2005. The sales in the

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

first quarter of 2006 included sales of Jessica Simpson and House of Dereon, compared to no such sales in the first quarter of 2005. As described elsewhere in this report, we will have no further sales of House of Dereon apparel and do not anticipate further sales of Jessica Simpson apparel in 2006.

Gross profit consists of net sales less product costs, direct labor, manufacturing overhead, duty, quota, freight in, and brokerage. Gross profit increased by \$3.6 million to \$12.5 million in the first quarter of 2006 from \$8.9 million in the first quarter of 2005. The increase in gross profit occurred primarily because of an increase in sales and gross margin. As a percentage of net sales, gross profit increased from 20.0% in the first quarter of 2005 to 20.4% in the first quarter of 2006. The improvement in gross margin is primarily attributable to the improved margins in the private label business due to expansion of our business to include more knitwear and woven tops at better margins using private brand product developments. We also experienced lower margins from sales of House of Dereon apparel during the quarter due to close out sales resulting from the termination of the House of Dereon license.

Selling and distribution expenses increased by \$368,000, or 14.4%, to \$2.9 million in the first quarter of 2006 from \$2.6 million in the first quarter of 2005. As a percentage of net sales, these expenses decreased to 4.8% in the first quarter of 2006 from 5.7% in the first quarter of 2005 due to the increase in sales during the first quarter of 2006.

General and administrative expenses increased by \$604,000, or 10.3%, to \$6.5 million in the first quarter of 2006 from \$5.9 million in the first quarter of 2005. As a percentage of net sales, these expenses decreased to 10.5% in the first quarter of 2006 from 13.1% in the first quarter of 2005 due to the increase in sales during the first quarter of 2006.

Royalty and marketing allowance expenses increased by \$1.2 million, or 403.1%, to \$1.5 million in the first quarter of 2006 from \$295,000 in the first quarter of 2005. The increase was primarily due to sales under the licensed Jessica Simpson brands, for which there were no such sales in the first quarter of 2005. As a percentage of net sales, these expenses increased to 2.4% in the first quarter of 2006 from 0.6% in the first quarter of 2005.

Operating income in the first quarter of 2006 was \$1.6 million, or 2.7% of net sales, compared to \$233,000, or 0.6% of net sales, in the comparable period of 2005, because of the factors discussed above.

Interest expense increased by \$375,000, or 46.1%, to \$1.2 million in the first quarter of 2006 from \$813,000 in the first quarter of 2005. As a percentage of net sales, this expense increased to 1.9% in the first quarter of 2006 from 1.8% in the first quarter of 2005. The increase in interest expense was primarily due to higher interest rates we paid on our short-term and long-term debts. Interest income decreased by \$68,000 or 12.3%, to \$485,000 in the first quarter of 2006 from \$553,000 in the first quarter of 2005. The interest income was primarily due to the interest earned from the notes receivable related to the sale of our fixed assets in Mexico. Interest in income of equity method investee was \$47,000 in the first quarter of 2006, compared to \$163,000 in the first quarter of 2005. Other income was \$34,000 in the first quarter of 2006, compared to \$65,000 in the first quarter of 2005. Other expense was \$0 in the first quarter of 2006, compared to \$6,000 in the first quarter of 2005.

Losses allocated to minority interests in the first quarter of 2006 were \$11,000, representing the minority partner's share of losses in PBG7. Earnings from the equity method investments, UAV and PBG7, totaled approximately \$57,000 for the first quarter of 2005. None of the profit in the equity method investments was allocated to the minority members in the first quarter of 2005 because we previously absorbed losses in excess of the minority members'

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

investment.

LIQUIDITY AND CAPITAL RESOURCES

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

23

cash to fund our operating expenses, capital expenditures and interest payments on our debt. In the long-term, we expect to use internally generated funds and external sources to satisfy our debt and other long-term liabilities.

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

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

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

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

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

Cash flows for the three months ended March 31, 2006 and 2005 were as follows (dollars in thousands):

CASH FLOWS:	2006	2005
	-----	-----
Net cash used in operating activities	\$3,332	\$9,576
Net cash provided by investing activities	\$ 438	\$2,481
Net cash provided by financing activities	\$1,752	\$6,082

During the first three months of 2006, net cash used in operating activities was \$3.3 million, as compared to net cash used in operating activities of \$9.6 million for the same period in 2005. Net cash used in

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

operating activities in the first quarter of 2006 resulted primarily from an increase of \$7.9 million in accounts receivable and a decrease of \$7.4 million in accounts payable, partially offset by income of \$836,000 and depreciation and amortization expense of \$373,000 and a decrease in inventory of \$9.8 million. The increase in accounts receivable and decrease in inventory was primarily due to the increase in sales in the first quarter of 2006, and the decrease in accounts payable resulted from the pay down of payables.

During the first three months of 2006, net cash provided by investing activities was \$438,000, as compared to net cash provided by investing activities of \$2.5 million in 2005. Net cash provided by investing activities in the first quarter of 2006 resulted primarily from approximately \$434,000 of collection on notes receivable.

During the first three months of 2006, net cash provided by financing activities was \$1.8 million, as compared to net cash provided by financing activities of \$6.1 million in 2005. Net cash provided by financing activities in 2006 resulted primarily from \$1.7 million net proceeds from our short-term bank borrowings.

24

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

Following is a summary of our contractual obligations and commercial commitments available to us as of March 31, 2006 (in millions):

CONTRACTUAL OBLIGATIONS	PAYMENTS DUE BY PERIOD				
	Total	Less than 1 year	Between 2-3 years	Between 4-5 years	After 5 years
Long-term debt (1)	\$ 39.6	\$ 39.6	\$ --	\$ --	\$ --
Convertible debentures, net	6.9	--	6.9	--	--
Operating leases	6.5	1.1	1.2	1.2	3.0
Minimum royalties	16.9	5.8	4.6	2.2	4.3
Purchase commitment	45.5	6.7	10.0	10.0	18.8
Total Contractual Cash Obligations	\$ 115.4	\$ 53.2	\$ 22.7	\$ 13.4	\$ 26.1

- (1) Excludes interest on long-term debt obligations. Based on outstanding borrowings as of March 31, 2006, and assuming all such indebtedness remained outstanding and the interest rates remained unchanged, we estimate that our interest cost on long-term debt would be approximately \$3.5 million.

COMMERCIAL COMMITMENTS AVAILABLE TO US	AMOUNT OF COMMITMENT EXPIRATION PER PERIOD				
	TOTAL AMOUNTS COMMITTED TO US	LESS THAN 1 YEAR	BETWEEN 2-3 YEARS	BETWEEN 4-5 YEARS	AFTER 5 YEARS

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

Lines of credit.....	\$	61.4	\$	61.4	\$	--	\$	--	\$
Letters of credit (within									
lines of credit).....	\$	16.4	\$	16.4	\$	--	\$	--	\$
Total commercial commitments....	\$	61.4	\$	61.4	\$	--	\$	--	\$

On June 13, 2002, we entered into a letter of credit facility of \$25 million with UPS Capital Global Trade Finance Corporation ("UPS"). Under this facility, we may arrange for the issuance of letters of credit and acceptances. The facility is collateralized by the shares and debentures of all of our subsidiaries in Hong Kong. In addition to the guarantees provided by Tarrant Apparel Group and our subsidiaries, Fashion Resource (TCL) Inc. and Tarrant Luxembourg Sarl, Gerard Guez, our Chairman and Interim Chief Executive Officer, also signed a guarantee of \$5 million in favor of UPS to secure this facility. This facility bore interest at 10.75% per annum at March 31, 2006. Under this facility, we were subject to certain restrictive covenants, including that we maintain a specified tangible net worth, fixed charge ratio, and leverage ratio. On June 27, 2005, we amended the letter of credit facility with UPS to extend the expiration date of the facility from June 30, 2005 to August 31, 2005 and to reduce the tangible net worth requirement at June 30, 2005. On August 31, 2005, we amended the letter of credit facility with UPS to further extend the expiration date of the facility to October 31, 2005, immediately reduce the maximum amount of borrowings to \$14.5 million on September 1, 2005 and further reduced the maximum amount of borrowing to \$14.0 million on October 1, 2005. On October 31, 2005, we further amended the letter of credit facility with UPS to extend the expiration date of the facility to January 31, 2006 and amend the interest rate to "prime rate" plus 3%. The facility amendment also provided for reduction in the maximum amount of borrowings to \$13.5 million commencing on November 1, 2005, to \$13.0 million commencing on December 1, 2005, and to \$12.5 million commencing on January 1, 2006. Additionally, Gerard Guez, our Chairman 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 January 27, 2006, we further amended the letter of credit facility with UPS to extend the expiration date of the facility from January 31, 2006 to July 31, 2006. The amendment provides for reduction of the maximum amount of borrowings under the facility to \$12.0 million commencing on April 1, 2006, \$11.5 million commencing on May 1, 2006, \$11.0 million commencing on June 1, 2006 and to \$10.5 million commencing on July 1, 2006. Under the amended letter of credit facility, we are subject to restrictive financial covenants of maintaining tangible net worth of \$25 million as of December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditures per quarter of \$800,000. As of March 31, 2006, we were in compliance with the covenants. As of March 31, 2006, \$8.0 million was outstanding under this facility with UPS and an additional \$2.5 million was available for future borrowings. In addition, \$2.0 million of open letters of credit was outstanding as of March 31, 2006.

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 is due and payable in 24 equal

monthly installments of approximately \$208,333 each, plus interest equivalent to the "prime rate" plus 2% commencing on February 1, 2005. This facility bore interest at 9.75% per annum at March 31, 2006. On June 27, 2005, we amended the

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

loan agreement with UPS to reduce the tangible net worth requirement at June 30, 2005. Under the amended loan agreement, we are subject to restrictive financial covenants of maintaining tangible net worth of \$25 million at December 31, 2005 and the last day of each fiscal quarter thereafter. There is also a provision capping maximum capital expenditure per quarter at \$800,000. As of March 31, 2006, we were in compliance with the covenants. As of March 31, 2006, \$2.1 million was outstanding. The obligations under the loan agreement are collateralized by the same security interests and guarantees provided under our letter of credit facility with UPS. Additionally, the term loan is secured by two promissory notes payable to Tarrant Luxembourg Sarl in the amounts of \$2,550,000 and \$1,360,000 and a pledge by Gerard Guez, our Chairman and Interim Chief Executive Officer, of 4.6 million shares of our common stock.

Since March 2003, DBS Bank (Hong Kong) Limited (formerly known as Dao Heng Bank) has made available a letter of credit facility of up to HKD 20 million (equivalent to US \$2.6 million) to our subsidiaries in Hong Kong. This is a demand facility and is secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and 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. As of March 31, 2006, \$2.5 million was outstanding under this facility. In addition, \$1.1 million of open letters of credit was outstanding and \$294,000 was available for future borrowings as of March 31, 2006. In October 2005, a tax loan for HKD 6.233 million (equivalent to US \$804,000) was also made available to our Hong Kong subsidiaries. As of March 31, 2006, \$478,000 was outstanding under this tax loan.

On October 1, 2004, we amended and restated our previously existing debt facility with GMAC Commercial Finance, 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. Pursuant to the terms of the PBG7 factoring agreement, PBG7 agreed to assign and sell to GMAC CF, as factor, all accounts, which arise from PBG7's sale of merchandise or rendition of services created on a going-forward basis. At PBG7's request, GMAC CF, in its discretion, may make advances to PBG7 up to the lesser of (a) up to 90% of PBG7's accounts on which GMAC CF has the risk of loss, and (b) \$5 million minus in each case, any amounts owed to GMAC CF by PBG7. The facility bore interest at 7.8256% per annum and the facility under PBG7, LLC bore interest at 8.25% per annum, respectively, at March 31, 2006. Restrictive covenants under the revised facility include a limit on quarterly capital expenses of \$800,000 and tangible net worth of \$25 million at December 31, 2005 and at the end of each fiscal quarter thereafter. As of March 31, 2006, we were in compliance with the covenants. A total of \$29.9 million was outstanding with respect to receivables factored under the GMAC CF facility at March 31, 2006.

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 will be reduced

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

to \$4 million on April 1, 2006 and will be further reduced to \$3 million on July 1, 2006. The maximum borrowing availability under the factoring agreement, based on the borrowing base formula remains at \$40 million. A total of \$4.5 million was outstanding under the GMAC CF facility at March 31, 2006 with respect to collateralized inventory.

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

The amount we can borrow under the new factoring facility with GMAC CF is determined based on a defined borrowing base formula related to eligible accounts receivable. A significant decrease in eligible accounts

26

receivable due to the aging of receivables, can have an adverse effect on our borrowing capabilities under our credit facility, which may adversely affect the adequacy of our working capital. In addition, we have typically experienced seasonal fluctuations in sales volume. These seasonal fluctuations result in sales volume decreases in the first and fourth quarters of each year due to the seasonal fluctuations experienced by the majority of our customers. During these quarters, borrowing availability under our credit facility may decrease as a result of decrease in eligible accounts receivables generated from our sales.

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

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

an expected life of four years. The \$620,000 financing cost paid to the placement agent and the value of the warrants to purchase 200,000 shares of our common stock of \$138,000 are included in the deferred financing cost, net on our accompanying balance sheets and are amortized over the life of the loan.

In June 2005, holders of our Debentures converted an aggregate of \$2.3 million of Debentures into 1,133,687 shares of our common stock. In August 2005, holders of our Debentures converted an aggregate of \$820,000 of Debentures into 410,000 shares of our common stock. The Debentures were converted at the option of the holders at a price of \$2.00 per share. Debt discount of \$248,000 related to the intrinsic value of the conversion option of \$804,000 was expensed upon the conversion. Of the \$620,000 financing cost paid to the placement agent, \$191,000 was expensed upon the conversion. The intrinsic value of the conversion option, and the value of the warrant amortized in the three months of 2005 was \$118,000. Total deferred financing cost amortized in three months of 2006 was \$47,000. Total interest paid to the holders of the Debentures in the three months of 2006 was \$104,000. As of March 31, 2006, \$6.1 million, net of \$829,000 of debt discount, remained outstanding under the Debentures.

On January 19, 2006, we borrowed \$4.0 million from Max Azria pursuant to the terms of a promissory note, which amount bears interest at the rate of 5.5% per annum and is payable in weekly installments of \$200,000 beginning on March 1, 2006. This is an unsecured loan. As of March 31, 2006, \$3.0 million was outstanding under this loan.

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. As of March 31, 2006, \$35,000 was outstanding under the two remaining loans.

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 March 31, 2006, \$1.5 million was outstanding under this facility (classified above under import trade bills payable) and \$3.2 million of letters of

27

credit were open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

On May 12, 2006, we entered into a commitment letter with Guggenheim Corporate Funding, LLC with respect to a \$65 million credit facility. The commitment letter contemplates that the credit facility will consist of an initial term loan of \$30 million, which will be used to repay certain existing indebtedness and fund our general operating and working capital needs, and a second term loan of \$35 million to be used, if at all, to finance acquisitions acceptable to Guggenheim. The credit facility would be secured by all or substantially all of our consolidated assets. Completion of the financing is subject to customary conditions precedent, including, without limitation, the preparation and execution of definitive loan documents, Guggenheim's completion and satisfaction with its legal due diligence review of us, obtaining all necessary consents and other third party approvals, and the preparation and execution of an inter-creditor agreement between the lenders and our other lenders.

We are also in negotiations with GMAC CF, UPS and DBS concerning our

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

credit facilities in effect with these lenders.

We have financed our operations from our cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt, and sales of equity and debt security. Our short-term funding relies very heavily on our major customers, banks, and suppliers. From time to time, we have had temporary over-advances from our banks. Any withdrawal of support from these parties will have serious consequences on our liquidity.

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

The Internal Revenue Service has proposed adjustments to our Federal income tax returns to increase our income tax payable for the years ended December 31, 1996 through 2001. This adjustment would also result in additional state taxes and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and, in particular, cash flow. We may not have an adequate cash reserve to pay the final adjustments resulting from the IRS examination. As a result, we may be required to arrange for payments over time or raise additional capital in order to meet these obligations. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the consolidated financial statements under the caption "Income Taxes." The maximum amount of loss in excess of the amount accrued in the financial statements is \$7.7 million. We do not believe that the adjustments, if any, arising from the IRS examination, will result in an additional income tax liability beyond what is recorded in the accompanying consolidated balance sheets.

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

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

RELATED PARTY TRANSACTIONS

We lease our executive offices in Los Angeles, California from GET, a corporation which is owned by Gerard Guez (our Chairman and Interim Chief Executive Officer) and Todd Kay (our Vice Chairman), both of which are significant shareholders. Additionally, we lease our warehouse and office space in Hong Kong from Lynx International Limited, a Hong Kong corporation that is owned by Messrs. Guez and Kay. We paid \$269,000 and

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

\$255,000 in rent in the three months ended March 31, 2006 and 2005, respectively, for office and warehouse facilities. Our Los Angeles offices and warehouse is leased on a month to month basis. On January 1, 2006, we renewed our lease agreement with Lynx International Limited for our office space in Hong Kong for one year.

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 March 31, 2006 was \$1.3 million of Mexico value added taxes on the real property component of this transaction. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, \$5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We purchased \$0 and \$840,000 of fabric from Acabados y Terminados in the three months ended March 31, 2006 and 2005, respectively. Net amount due from these parties as of March 31, 2006 was \$507,000.

From time to time in the past, we borrowed funds from, and advanced funds to, Mr. Guez. The greatest outstanding balance of such advances to Mr. Guez in the first quarter of 2006 was approximately \$2,279,000. At March 31, 2006, the entire balance due from Mr. Guez totaling \$2.3 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All advances to, and borrowings from, Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was \$44,000 and \$74,000 for the three months ended March 31, 2006 and 2005, respectively. Mr. Guez paid expenses on our behalf of approximately \$67,000 and \$108,000 for the three months ended March 31, 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 economies of scale with Azteca Production International, Inc. ("Azteca"), a corporation owned by the brothers of Gerard Guez, our Chairman, called United Apparel Ventures, LLC ("UAV"). This entity was created to coordinate the production of apparel for a single customer of our branded business. UAV is owned 50.1% by Tag Mex, Inc., our wholly owned subsidiary, and 49.9% by Azteca. Results of the operation of UAV have been consolidated into our results since July 2001 with the minority partner's share of gain and losses eliminated through the minority interest line in our financial statements. Due to the restructuring of our Mexico operations, we discontinued manufacturing for UAV customers in the second quarter of 2004. UAV made purchases from two related parties in Mexico, an affiliate of Azteca and Tag-It Pacific, Inc.

At March 31, 2006, Messrs. Guez and Kay beneficially owned 590,000 and 1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc. ("Tag-It"), collectively representing approximately 8.7% of Tag-It Pacific's

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

common stock. Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. Starting from 1998, Tag-It assumed the responsibility for managing and sourcing all trim and packaging used in connection with products manufactured by or on behalf of us in Mexico. Due to the restructuring of our Mexico operations, Tag-It no longer manages our trim and packaging requirements. We purchased \$97,000 and \$0 of trim inventory from Tag-It in the three months ended March 31, 2006 and 2005, respectively. We purchased \$0 and \$135,000 of finished goods and service from Azteca and its affiliates in the three months ended March 31, 2006 and 2005, respectively. Our total sales of fabric and service to Azteca in the three months ended March 31, 2006 and 2005 were \$9,000 and \$63,000, respectively. Pursuant to the operating agreement for UAV, two and one half percent of gross sales of UAV were paid to each of the members of UAV as management fees. Net amount due from these related parties as of March 31, 2006 was \$5.6 million.

29

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

30

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

FOREIGN CURRENCY RISK. Our earnings are affected by fluctuations in the value of the U.S. dollar as compared to foreign currencies as a result of doing business in foreign jurisdictions. As a result, we bear the risk of exchange rate gains and losses that may result in the future. At times we use forward exchange contracts to reduce the effect of fluctuations of foreign currencies on purchases and commitments. These short-term assets and commitments are principally related to trade payables positions. We do not utilize derivative financial instruments for trading or other speculative purposes. We actively evaluate the creditworthiness of the financial institutions that are counter parties to derivative financial instruments, and we do not expect any counter parties to fail to meet their obligations.

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

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

ITEM 4. CONTROLS AND PROCEDURES.

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

EVALUATION OF CONTROLS AND PROCEDURES

Members of the our management, including our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as defined by paragraph (e) of Exchange Act Rules 13a-15 or 15d-15, as of March 31, 2006, the end of the period covered by this report. Members of the our management, including our Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the further quarter of 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

CHANGES IN CONTROLS AND PROCEDURES

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

31

PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands 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. The 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, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto, 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. On or about April 26, 2006, Camuto 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. On or about April 17, 2006, Ms. Simpson served a motion seeking dismissal of the cause of action asserted against her. We intend to vigorously defend Camuto's counterclaim and vigorously oppose Ms. Simpson's motion.

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

ITEM 1A. RISK FACTORS.

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

RISKS RELATED TO OUR BUSINESS

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

Four customers accounted for approximately 49% of our net sales in first three months of 2006. We believe that consolidation in the retail industry has centralized purchasing decisions and given customers greater leverage over suppliers, like us, and we expect this trend to continue. If this consolidation continues, our net sales and results of operations may be increasingly sensitive to deterioration in the financial condition of, or other adverse developments with, one or more of our customers.

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

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

32

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

Because the bulk of our freight is designed to move through the West Coast ports in predictable time frames, we are at risk of cancellations and penalties when those ports operate inefficiently creating delays in delivery. We experienced such delays from June 2004 until November 2004, and we may experience similar delays in the future especially during peak seasons. Unpredictable timing for shipping may cause us to utilize air freight or may result in customer penalties for late delivery, any of which could reduce our operating margins and adversely affect our results of operations.

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

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

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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

We are currently in litigation with the licensors of the Jessica Simpson brands regarding our rights to sell apparel under these brands. See Part II of this report, Item 1 "Legal Proceedings" for a detailed description of this lawsuit. The licensor has filed a counterclaim against us seeking damage. These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made against us, and intend to contest the lawsuit vigorously, no assurances can be given that the results of these matters will be favorable to us. An adverse resolution of any of these lawsuits could have a material adverse affect on our financial position and results of operations. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

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

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

OUR OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY.

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

33

WE DEPEND ON OUR COMPUTER AND COMMUNICATIONS SYSTEMS.

As a multi-national corporation, we rely on our computer and communication network to operate efficiently. Any interruption of this service from power loss, telecommunications failure, weather, natural disasters or any

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

similar event could have a material adverse affect on our business and operations. Additionally, hackers and computer viruses have disrupted operations at many major companies. We may be vulnerable to similar acts of sabotage, which could have a material adverse effect on our business and operations.

WE MAY REQUIRE ADDITIONAL CAPITAL IN THE FUTURE.

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

OUR BUSINESS IS SUBJECT TO RISKS ASSOCIATED WITH IMPORTING PRODUCTS.

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

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

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

We depend on independent contract manufacturers to secure a sufficient supply of raw materials and maintain sufficient manufacturing and shipping capacity in an environment characterized by declining prices, labor shortage, continuing cost pressure and increased demands for product innovation and speed-to-market. This dependence could subject us to difficulty in obtaining timely delivery of products of acceptable quality. In addition, a contractor's failure to ship products to us in a timely manner or to meet the required quality standards could cause us to miss the delivery date requirements of our

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

customers. The failure to make timely deliveries may cause our customers to cancel orders, refuse to accept deliveries, impose non-compliance charges through invoice deductions or other charge-backs, demand reduced prices or reduce future orders, any of which could harm our sales, reputation and overall profitability. We do not have material long-term contracts with any of our independent contractors and any of these contractors may unilaterally terminate their relationship with us at any time. To the extent we are not able to secure or maintain relationships with independent contractors that are able to fulfill our requirements, our business would be harmed.

34

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

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

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

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

Approximately 90% of our products were imported from outside the U.S. in fiscal 2005. We are subject to the risks associated with doing business in foreign countries, including, but not limited to, transportation delays and interruptions, political instability, expropriation, currency fluctuations and the imposition of tariffs, import and export controls, other non-tariff barriers and cultural issues. Any changes in those countries' labor laws and government regulations may have a negative effect on our profitability.

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

RISK ASSOCIATED WITH OUR INDUSTRY

OUR SALES ARE HEAVILY INFLUENCED BY GENERAL ECONOMIC CYCLES.

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

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

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

- o anticipating and quickly responding to changing consumer demands;
- o developing innovative, high-quality products in sizes, colors and styles that appeal to consumers of varying age groups and tastes;
- o competitively pricing our products and achieving customer perception of value; and

35

- o the need to provide strong and effective marketing support.

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

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

OUR BUSINESS IS SUBJECT TO SEASONAL TRENDS.

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

OTHER RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

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

In January 2004, the Internal Revenue Service proposed adjustments to increase our federal income tax payable for the years ended December 31, 1996 through 2001. This adjustment would also result in additional state taxes, penalties and interest. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. In March 2005, the IRS proposed an adjustment to our taxable income of approximately \$6 million related to similar issues identified in their audit of the 1996 through 2001 federal income tax returns. We believe that we have meritorious defenses to and intend to vigorously contest the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002. If the proposed adjustments are upheld through the administrative and legal process, they could have a material impact on our earnings and cash flow. We believe we have provided adequate reserves for any reasonably foreseeable outcome related to these matters on the consolidated balance sheets included in the Consolidated Financial Statements. The maximum amount of loss in excess of the amount accrued in the financial statements is \$7.7 million. If the amount of any actual liability, however, exceeds our reserves, we would experience an immediate adverse earnings impact in the amount of such additional liability, which could be material. Additionally, we anticipate that the ultimate resolution of these matters will require that we make significant cash payments to the taxing authorities. Presently we do not have sufficient cash or borrowing ability to make any future payments that may be required. No assurance can be given that we will have sufficient surplus cash from operations to make the required payments. Additionally, any cash used for these purposes will not be available for other corporate purposes, which could have a material adverse effect on our financial condition and results of operations.

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

As of March 31, 2006, our executive officers and directors and their affiliates owned approximately 43% of the outstanding shares of our common stock. Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman, alone own approximately 33.1% and 8.4%, respectively, of the outstanding shares of our common stock at March 31, 2006. Accordingly, our executive officers and directors have the ability to affect the outcome of, or exert considerable influence over, all matters requiring shareholder approval, including the election and removal of directors and any change in control. This concentration of ownership of our common stock could have the effect of delaying or preventing a change of control of us or otherwise discouraging or preventing a potential acquirer from attempting to obtain control of us. This, in turn, could have a negative effect on the market

36

price of our common stock. It could also prevent our shareholders from realizing a premium over the market prices for their shares of common stock.

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

Our shareholders rights plan, our ability to issue additional shares of preferred stock and some provisions of our articles of incorporation and bylaws could make it more difficult for a third party to make an unsolicited takeover

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price without approval of our board of directors.

OUR STOCK PRICE HAS BEEN VOLATILE.

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

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

ABSENCE OF DIVIDENDS COULD REDUCE OUR ATTRACTIVENESS TO YOU.

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

37

ITEM 6. EXHIBITS.

EXHIBIT NUMBER -----	DESCRIPTION -----
10.8.2	Amendment to Factoring Agreement dated as of January 23, 2006 by and among GMAC Commercial Finance LLC and Tarrant Apparel Group, Fashion Resource (TCL), Inc., TAG Mex, Inc., United Apparel Ventures, LLC, Private Brands, Inc. and NO! Jeans, Inc.
10.16.24	Sixteenth Deed of Variation to Syndicated Letter of Credit Facility effective as of January 31, 2006

Edgar Filing: TARRANT APPAREL GROUP - Form 10-Q

among Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited and UPS Capital Global Trade Finance Corporation.

- 10.34 Promissory Note in the principal amount of \$4,000,000 dated as of January 19, 2006, issued by Tarrant Apparel Group in favor of Max Azria.
- 31.1 Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
- 31.2 Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
- 32.1 Certificate of Chief Executive Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
- 32.2 Certificate of Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.

38

SIGNATURES

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

TARRANT APPAREL GROUP

Date: May 15, 2006

By: /s/ Corazon Reyes

Corazon Reyes,
Chief Financial Officer

Date: May 15, 2006

By: /s/ Gerard Guez

Gerard Guez,
Interim Chief Executive Officer

39