TARRANT APPAREL GROUP
Form 10-Q
August 13, 2007

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. FOR THE TRANSITION PERIOD FROM ________ TO ________.

COMMISSION FILE NUMBER: 0-26006

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

CALIFORNIA	95-4181026
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

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

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

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

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

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

Number of shares of Common Stock of the Registrant outstanding as of August 10, 2007: 30,543,763.

TARRANT APPAREL GROUP
FORM 10-Q
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CAUTIONARY LEGEND REGARDING FORWARD-LOOKING STATEMENTS

Some of the information in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. These forward-looking statements are subject to various risks and uncertainties. The forward-looking statements include, without limitation, statements regarding our future business plans and strategies and our future financial position or results of operations, as well as other statements that are not historical. You can find many of these statements by looking for words like "will", "may", "believes", "expects", "anticipates", "plans" and "estimates" and for similar expressions. Because forward-looking statements involve risks and uncertainties, there are many factors that could cause the actual results to differ materially from those expressed or implied. These

include, but are not limited to, economic conditions. This Quarterly Report on Form 10-Q contains important cautionary statements and a discussion of many of the factors that could materially affect the accuracy of Tarrant's forward-looking statements and such statements and discussions are incorporated herein by reference. Any subsequent written or oral forward-looking statements made by us or any person acting on our behalf are qualified in their entirety by the cautionary statements and factors contained or referred to in this section. We do not intend or undertake any obligation to update any forward-looking statements to reflect events or circumstances after the date of this document or the date on which any subsequent forward-looking statement is made or to reflect the occurrence of unanticipated events.

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PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

TARRANT APPAREL GROUP
CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2007	DECEMBER 31, 2006
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 963,858	$ 904,553
Accounts receivable, net of $1.9 million and $2.1 million allowance for returns, discounts and bad debts at June 30, 2007 and December 31, 2006, respectively	46,789,279	48,079,527
Due from related parties	4,980,533	3,688,355
Inventory	18,221,411	17,774,103
Temporary quota rights	38,770	32,217
Prepaid expenses	1,096,052	1,515,087
Deferred tax assets	125,401	123,607
Income taxes receivable	26,267	25,468
Total current assets	72,241,571	72,142,917
Property and equipment, net of $9.5 million and $9.4 million accumulated depreciation at June 30, 2007 and December 31, 2006, respectively	1,479,197	1,414,354
Notes receivable - related parties, net of $27.1 million reserve at June 30, 2007 and December 31, 2006	14,000,000	14,000,000
Due from related parties	3,554,117	4,168,205
Equity method investment	2,277,603	2,151,061
Deferred financing cost, net of $1.4 million and $1.7 million accumulated amortization at June 30, 2007 and December 31, 2006, respectively	1,951,043	2,448,526
Other assets	220,670	6,223,816
Goodwill, net	8,582,845	8,582,845
Total assets	$ 104,307,046	$ 111,131,724

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Short-term bank borrowings	$ 14,841,935	$ 13,696,182
Accounts payable	19,011,466	22,685,674
Accrued expenses	10,021,269	8,907,658
Derivative liability	--	195,953
Income taxes	18,253,199	16,865,125
Current portion of long-term obligations and factoring arrangement	13,337,908	19,586,565
Total current liabilities	75,465,777	81,937,157
Term loan, net of $3.7 million and $4.3 million debt discount at June 30, 2007 and December 31, 2006, respectively	11,754,274	11,212,724
Other long-term obligations	--	5,338
Total liabilities	87,220,051	93,155,219
Minority interest in PBG7	52,890	54,338
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized; no shares at June 30, 2007 and December 31, 2006 issued and outstanding	--	--
Common stock, no par value, 100,000,000 shares authorized; 30,543,763 shares at June 30, 2007 and December 31, 2006 issued and outstanding	114,977,465	114,977,465
Warrant to purchase common stock	7,314,239	7,314,239
Contributed capital	10,413,586	10,191,511
Accumulated deficit (See Note 12)	(113,602,018)	(112,410,363)
Notes receivable from officer/shareholder	(2,069,167)	(2,150,685)
Total shareholders' equity	17,034,105	17,922,167
Total liabilities and shareholders' equity	$ 104,307,046	$ 111,131,724

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

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TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED JUNE 30		SIX MONTHS ENDED	
	2007	2006	2007	

Net sales	$ 60,100,503	$ 59,082,541	$ 116,207,097	$ 1
Cost of sales	47,545,805	46,419,973	91,305,819	
Gross profit	12,554,698	12,662,568	24,901,278	
Selling and distribution expenses	3,352,007	2,798,086	6,790,740	
General and administrative expenses	6,240,358	6,903,093	12,726,954	
Royalty expenses	433,696	352,864	791,428	
Terminated acquisition expenses	--	--	2,000,000	
Income from operations	2,528,637	2,608,525	2,592,156	
Interest expense	(1,219,562)	(1,945,797)	(2,562,886)	
Interest income	42,857	480,859	87,957	
Interest in income of equity method investee	42,793	62,909	126,542	
Other income	64,748	90,568	152,399	
Adjustment to fair value of derivative	524	(218,307)	195,953	
Other expense	(9,335)	(400,000)	(11,140)	
Income before provision for income taxes	1,450,662	678,757	580,981	
Provision for income taxes	641,917	60,110	774,084	
Minority interest	519	(7,363)	1,448	
Net income (loss)	$ 809,264	$ 611,284	$ (191,655)	$
Net income (loss) per share:				
Basic	$ 0.03	$ 0.02	$ (0.01)	$
Diluted	$ 0.03	$ 0.02	$ (0.01)	$
Weighted average common and common equivalent shares:				
Basic	30,543,763	30,543,763	30,543,763	
Diluted	30,543,875	30,544,420	30,543,763	

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

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TARRANT APPAREL GROUP

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	SIX MONTHS ENDED JUNE 30, 2007	2006
Operating activities:		

Net income (loss)	$ (191,655)	$ 1,447,655
Adjustments to reconcile net income (loss) to net cash provided by (used in) Operating activities:		
Deferred taxes	(1,794)	(22,414)
Depreciation and amortization of fixed assets	201,339	246,965
Amortization of deferred financing cost	987,036	1,534,973
Adjustment to fair value of derivative	(195,953)	218,307
Terminated acquisition expenses	2,000,000	--
Change in the provision for returns and discounts	(204,624)	277,656
Change in the provision for bad debts	40,081	(5,440)
Loss (gain) on sale of fixed assets	6,145	(1,283)
Income from equity method investment	(126,542)	(110,322)
Minority interest	(1,448)	(4,131)
Stock-based compensation	321,761	7,054
Changes in operating assets and liabilities:		
Accounts receivable	1,953,928	(5,789,823)
Due to/from related parties	(1,277,229)	(121,160)
Inventory	(447,308)	11,440,735
Temporary quota rights	(6,553)	(59,153)
Prepaid expenses	418,235	1,353,074
Accounts payable	(3,674,208)	(12,295,638)
Accrued expenses and income tax payable	1,501,684	(518,128)
Net cash provided by (used in) operating activities	1,302,895	(2,401,073)
Investing activities:		
Purchase of fixed assets	(272,327)	(63,418)
Proceeds from sale of fixed assets	--	2,800
Due diligence fees in acquisition	(699,764)	--
Refund of deposit on acquisition	4,750,000	--
Distribution from equity method investee	--	67,500
Collection on notes receivable - related parties	--	651,666
Collection of advances from shareholders/officers	81,519	44,522
Net cash provided by investing activities	3,859,428	703,070
Financing activities:		
Short-term bank borrowings, net	1,145,754	(1,300,390)
Proceeds from long-term obligations	98,640,912	132,805,154
Payment of financing costs	--	(2,231,318)
Repayments of borrowings from convertible debentures	--	(6,912,626)
Payment of long-term obligations and bank borrowings	(104,889,684)	(120,613,274)
Net cash provided by (used in) financing activities	(5,103,018)	1,747,546
Increase in cash and cash equivalents	59,305	49,543
Cash and cash equivalents at beginning of period	904,553	1,641,768
Cash and cash equivalents at end of period	$ 963,858	$ 1,691,311

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

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. ORGANIZATION AND BASIS OF CONSOLIDATION

The accompanying financial statements consist of the consolidation of Tarrant Apparel Group, a California corporation, and its majority owned subsidiaries located primarily in the U.S., Asia, Mexico, and Luxembourg. At June 30, 2007, we own 75% of PBG7, LLC ("PBG7"). We previously owned 50.1% of United Apparel Ventures ("UAV"), which was dissolved on February 27, 2007. The dissolution of UAV did not have a material impact on our consolidated financial statements. 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 was 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 merchandisers and department store chains and branded wholesalers by designing, merchandising, contracting for the manufacture of, and selling casual apparel for women, men and children under private label and private brand.

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 generally accepted accounting principles 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, 2006 is derived from audited financial statements which are included in our Annual Report on Form 10-K for the year ended December 31, 2006, 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.

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates used by us in preparation of the consolidated financial statements include allowance for returns, discounts and bad debts, inventory, notes receivable - related parties reserve, valuation of long-lived and intangible assets and goodwill, income taxes, stock options valuation, contingencies and litigation. Actual results could differ from those estimates.

LICENSE AGREEMENTS AND ROYALTY EXPENSES

We enter into license agreements from time to time that allow us to use certain trademarks and trade names on certain of our products. These agreements require us to pay royalties and marketing fund commitments, generally based on the sales of such products, and may require guaranteed minimum royalties, a portion of which may be paid in advance. Our accounting policy is to match royalty expense with revenue by recording royalties at the time of sale at the greater of the contractual rate or an effective rate calculated based on the guaranteed minimum royalty and our estimate of sales during the contract period. If a portion of the guaranteed minimum royalty is determined not to be recoverable, the unrecoverable portion is charged to expense at that time. See Note 15 of the "Notes to Consolidated Financial Statements" regarding various agreements we have entered into.

Royalty expense in the six months ended June 30, 2007 and 2006 were $791,000 and $1.8 million, respectively.

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 June 30, 2007 and December 31, 2006, deferred rent of $133,000 and $93,000, respectively, was recorded under accrued expense in our consolidated financial statements.

DERIVATIVE ACTIVITIES

WARRANT DERIVATIVES

Statement of Financial Accounting Standards ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities" requires measurement of certain derivative instruments at their fair value for accounting purposes. In determining the appropriate fair value, we use the

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

FOREIGN CURRENCY FORWARD CONTRACT

We source our product in a number of countries throughout the world, as a result, are exposed to movements in foreign currency exchange rates. The primary purpose of our foreign currency hedging activities is to manage the volatility associated with foreign currency purchases of materials in the normal course of business. We utilize derivative financial instruments consisting primarily of forward currency contracts. These instruments are intended to protect against exposure related to financing transactions and income from international operations. We do not enter into derivative financial instruments for speculative or trading purposes. We enter into certain foreign currency derivative instruments that do not meet hedge accounting criteria.

SFAS No. 133 requires measurement of certain derivative instruments at their fair value for accounting purposes. All derivative instruments are recorded on our balance sheet at fair value; as a result, we mark to market all derivative instruments. Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in consolidated statements of operations as adjustments to fair value of derivatives. During 2006, we entered into foreign currency forward contracts to hedge against the effect of exchange rate fluctuations on cash flows denominated in foreign currencies and certain inter-company financing transactions. At June 30, 2007, we had no open foreign exchange forward contracts. Hedge ineffectiveness resulted in an impact of $196,000 in our consolidated statements of operations in the six months of 2007.

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TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

ACCOUNTING FOR UNCERTAIN TAX POSITIONS

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109," ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment for unrecognized tax benefits but reduced retained earnings as of January 1, 2007 by approximately $1 million attributable to penalties accrued as a component of income tax payable. As of the date of adoption, our unrecognized tax benefits totaled approximately $8.9 million.

We and several of our subsidiaries file income tax returns in the U.S.,

Hong Kong, Luxembourg, Mexico and various state jurisdictions. We are currently subject to Internal Revenue Service ("IRS") audit for the years including 1996 through 2002 but are not being audited for state or non-U.S. income tax examinations for years open in those taxing jurisdictions.

In January 2004, the 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. We are currently at the appellate level of the IRS and believe the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002 will be resolved within the next twelve months and if so, unrecognized tax benefits related to U.S. tax positions may decrease by up to $6.2 million by December 31, 2007. 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 under the caption "Income Taxes". 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.

The total unrecognized tax benefits as of January 1, 2007 were $8.9 million, excluding interest, penalties and related income tax benefits and would be recorded as a component of income tax expense if recognized. We recognize interest accrued related to unrecognized tax benefits and penalties as a component of income tax expense. As of January 1, 2007, the accrued interest and penalties were $8.0 million and $1.2 million, respectively, excluding any related income tax benefits. As of June 30, 2007, the unrecognized tax benefits did not change from the date of adoption.

In many cases, the uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. Federal and state statutes are open from 1996 through the present period. Hong Kong statutes are open from 2001, Luxembourg from 2003 and Mexico from 2001.

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

3. STOCK BASED COMPENSATION

Our Employee Incentive Plan, formerly the 1995 Stock Option Plan (the "1995 Plan"), authorized the grant of both incentive and non-qualified stock options to our officers, employees, directors and consultants for shares of our common stock. As of June 30, 2007, there were outstanding options to purchase a total of 1,041,000 shares of common stock granted under the 1995 Plan. No further grants may be made under the 1995 Plan. On May 25, 2006, we adopted the Tarrant Apparel Group 2006 Stock Incentive Plan (the "2006 Plan"), which authorizes the issuance of up to 5,100,000 shares of our common stock pursuant to options or awards granted under the 2006 Plan. As of June 30, 2007, there were outstanding options to purchase a total of 1,858,000 shares of common stock, and 3,242,000 shares remained available for issuance pursuant to award granted under the 2006 Plan. The exercise price of options under the plan must be equal to 100% of fair

market value of common stock on the date of grant. The 2006 Plan also permits other types of awards, including stock appreciation rights, restricted stock and other performance-based benefits.

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), "Share-Based Payment," ("SFAS No. 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 No. 123(R) supersedes our previous accounting under Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 107 relating to SFAS No. 123(R). We have applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

We adopted SFAS No. 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 and six months ended June 30, 2007 and 2006 reflect the impact of SFAS No. 123(R). SFAS No. 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.

A summary of our stock option activity, and related information for the year ended December 31, 2006 and the six months ended June 30, 2007 is as follows:

	EMPLOYEES	
	NUMBER OF SHARES	EXERCISE PRICE
Options outstanding at December 31, 2005	6,733,050	$1.39-$45.50
Granted	1,233,259	$ 1.84-$1.94
Exercised	--	--
Forfeited	(19,650)	$1.94-$33.13
Expired	(273,000)	$ 6.75-$7.38
Options outstanding at December 31, 2006	7,673,659	$1.39-$45.50
Granted	630,000	$ 1.63-$1.99
Exercised	--	--
Forfeited	(2,000)	$ 18.50
Expired	(2,000)	$ 8.50
Options outstanding at June 30, 2007	8,299,659	$1.39-$45.50

We had no stock option outstanding to non-employees as of December 31, 2006 and June 30, 2007.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

The following table summarizes information about stock options outstanding as of December 31, 2006 and June 30, 2007:

	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	INTRINSIC VALUE
As of December 31, 2006				
Employees - Outstanding	7,673,659	$ 5.52	5.9	$ 0
Employees - Expected to vest	7,579,083	$ 5.57	5.9	$ 0
Employees - Exercisable	6,445,400	$ 6.22	5.3	$ 0
As of June 30, 2007:				
Employees - Outstanding	8,299,659	$ 5.24	5.8	$ 0
Employees - Expected to vest	8,156,573	$ 5.30	5.7	$ 0
Employees - Exercisable	6,684,715	$ 6.05	4.9	$ 0

The following table summarizes our non-vested options as of December 31, 2006 and changes during the six months ended June 30, 2007:

NON-VESTED OPTIONS	NUMBER OF SHARES	WEIGHTED AVERAGE GRANT-DATE FAIR VALUE
Non-vested at December 31, 2006	1,228,259	$ 1.26
Granted	630,000	$ 1.28
Vested	(243,315)	$ 1.25
Forfeited	--	--
Non-vested at June 30, 2007	1,614,944	$ 1.27

The following table shows the fair value of each option granted to employees and directors estimated on the date of grant using the Black-Scholes model with the following weighted average assumptions used for grants in the six months ended June 30, 2007 and 2006:

	SIX MONTHS ENDED JUNE 30, 2007	2006
Expected dividend	0.0%	0.0%
Risk free interest rate	4.49% to 4.67%	5.13%
Expected volatility	70%	70%
Expected term (in years)	5.75 to 6.18	6.25

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the consolidated statements of operations for the three months and six months ended June 30, 2007 and 2006 consisted of compensation expense for the share-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). For stock-based payment awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method. As stock-based compensation expense recognized in the consolidated statements of operations for the three months and six months ended June 30, 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures, which we estimate to be 7.7%. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Our determination of fair value of share-based payment awards to employees and directors on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to our expected stock price volatility over the term of the awards. When valuing awards, we estimate the expected terms using the "safe harbor" provisions provided in SAB No. 107 and the volatility using historical data. We granted 973,259 shares of stock options to purchase shares of common stock for the six months ended June 30, 2006. The options granted were fair valued in the aggregate at $1.2 million or the weighted-average exercise of $1.25 in the six months ended June 30, 2006. We granted 630,000 shares of options in the six months ended June 30, 2007. The options granted were fair valued in the aggregate at $805,000 or the weighted-average exercise of $1.92 in the six months ended June 30, 2007. The stock-based compensation expense related to employees or director stock options recognized for the six months ended June 30, 2007 was $322,000, of which $93,000 was recorded under general and administrative expenses and $229,000 was recorded under selling and distribution expenses in our consolidated statements of operation. The stock-based compensation expense related to employees or director stock options recognized for the six months ended June 30, 2006 was $7,000 which was recorded under general and administrative expenses in our consolidated statements of operation. Basic and dilutive income per share for the three months ended June 30, 2007, and for the three months and six months ended June 30, 2006 was not materially affected by the additional stock-based compensation recognized. Basic and dilutive earnings per share for the six months ended June 30, 2007 was decreased by $0.01 from $0.00 to $(0.01) by the additional stock-based compensation recognized.

The total intrinsic value of options exercised for the three months and six months ended June 30, 2007 and 2006 was $0. Cash received from stock options exercised for the three months and six months ended June 30, 2007 and 2006 was $0. The total fair value of shares vested for the six months ended June 30, 2007 and 2006 were approximately $304,000 and $0, respectively.

As of June 30, 2007, there was $1.8 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over the

weighted-average period of 2.9 years.

When options are exercised, our policy is to issue previously unissued shares of common stock to satisfy share option exercises. As of June 30, 2007, we had 69.5 million shares of authorized, unissued shares of common stock.

4. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	JUNE 30, 2007	DECEMBER 31, 2006
U.S. trade accounts receivable	$ 3,639,079	$ 2,975,840
Foreign trade accounts receivable	15,694,183	16,986,357
Factored accounts receivable	28,658,895	29,697,935
Other receivables	709,438	496,253
Allowance for returns, discounts and bad debts	(1,912,316)	(2,076,858)
	$ 46,789,279	$ 48,079,527

5. INVENTORY

Inventory consists of the following:

	JUNE 30, 2007	DECEMBER 31, 2006
Raw materials - fabric and trim accessories...	$ 3,155,130	$ 3,271,610
Work in process	13,065	--
Finished goods shipments-in-transit	7,311,640	7,331,422
Finished goods	7,741,576	7,171,071
	$ 18,221,411	$ 17,774,103

6. NOTES RECEIVABLE - RELATED PARTY RESERVE

In connection with the sale in 2004 of our assets and real property in Mexico, the purchasers of the Mexico assets, Solticio, S.A. de C.V. ("Solticio"), and Acabados y Cortes Textiles, S.A. de C.V. ("Acotex"), issued us unsecured promissory notes of $3,910,000 that mature on November 30, 2007 and secured promissory notes of $40,204,000 with payments due 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. The secured notes are secured by the real and personal property in Mexico

that we sold to the purchasers. As of September 30, 2006, the outstanding balance of the notes and interest receivables was $41.1 million prior to the reserve. Historically, we had placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we had satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, during the third quarter of 2006, the purchasers ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in the third quarter of 2006 in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately $27.1 million, resulting in a net notes receivable balance at September 30, 2006 of approximately $14 million. We believe there was no significant change subsequently on the value of the underlying assets securing the notes; therefore, we did not have additional reserve after the third quarter of 2006. We will continue to pursue payment of all amounts under the notes receivable and believe the remaining $14 million balance at June 30, 2007 is realizable.

On March 21, 2007, our wholly-owned subsidiary, Tarrant Luxembourg S.a.r.l., entered into a letter agreement with Solticio, Inmobiliaria Cuadros, S.A. de C.V. ("Inmobiliaria"), and Acotex, (Acotex and together with Solticio and Inmobiliaria, the "Sellers"), and Tavex Algodonera, S.A. ("Tavex"). On July 19, 2007, the parties amended the letter agreement.

Pursuant to the agreement, as amended, Tavex has the right and option (but not an obligation), at any time on or prior to September 1, 2007, to pay to Tarrant Luxembourg an aggregate of U.S. $17.75 million in cash, whereupon, among other things:

- o Tarrant Luxembourg will terminate the Solticio and Acotex promissory notes described above and release the Sellers from any further obligations thereunder, and terminate and release all liens on the collateral securing those notes;

- o Tarrant Luxembourg and the Sellers will terminate all other executory obligations among the parties, including any obligation of ours to purchase fabric from Soliticio and Acotex; and

- o Tarrant Luxembourg would agree to purchase from Tavex at least U.S. $1.25 million of fabric prior to the end of 2007, and Tarrant Luxembourg would deliver a irrevocable letter of credit for the full purchase price.

Tavex is not obligated to exercise the option and the terms and conditions of the letter could change prior to the expiration period. During the option period, we agreed that we would not seek to enforce the Solticio and Acotex promissory notes, including by taking action with respect to the collateral, nor would we enter into any agreement with a third party that would adversely affect Tavex's rights under the agreement.

The Sellers also agreed during the option period, to work exclusively with Tavex in respect of the payment of the Solticio and Acotex promissory notes and the other transactions contemplated by the letter agreement, and not to enter into any agreement with any person other than Tavex with respect to the payment and/or assignment of the Solticio and Acotex promissory notes and the transactions contemplated by the agreement.

7. 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 advance in monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. If a portion of the guaranteed minimum royalty is determined not to be recoverable, the unrecoverable portion is charged to expense at that time. The guaranteed annual minimum royalty for 2007 is $760,000. At June 30, 2007, the total commitment on royalties remaining on the term was $8.0 million. Private Brands also entered into a multi-year exclusive distribution agreement with Macy's Merchandising Group, LLC ("MMG"), the sourcing arm of Federated Department Stores, to supply MMG with American Rag CIE, a casual sportswear collection for juniors and young men. Under this arrangement, Private Brands designs and manufactures American Rag apparel, which is distributed by MMG exclusively to Federated stores across the country. Beginning in August 2003, the American Rag collection was available in approximately 100 select Macy's locations and is currently available in approximately 600 Macy's stores nationally. The investment in American Rag CIE, LLC totaling $2.3 million at June 30, 2007, 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 six month ended June 30, 2007 was as follows:

Balance as of December 31, 2006	$ 2,151,061
Share of income	126,542
Distribution	(0)
Balance as of June 30, 2007	$ 2,277,603

8. OTHER ASSETS AND WRITE OFF OF ACQUISITION EXPENSES

On December 6, 2006, we entered into a definitive stock and asset purchase agreement (the "Purchase Agreement") to acquire certain assets and entities comprising The Buffalo Group. The Buffalo Group designs, imports and sells contemporary branded apparel and accessories, primarily in Canada and the United States.

Pursuant to the Purchase Agreement, we and our subsidiaries agreed to acquire (1) all the outstanding capital stock of four principal operating subsidiaries of The Buffalo Group - Buffalo Inc., 3163946 Canada Inc., 3681441 Canada Inc. and Buffalo Corporation, and (2) certain assets, consisting primarily of intellectual property rights and licenses, from The Buffalo Trust, for a total aggregate purchase price of up to approximately $120 million consisting of:

- $40 million in cash, subject to reduction prior to closing;
- $15 million in promissory notes that are due and payable in five equal annual installments beginning on the second anniversary of the closing date;

- The issuance to the sellers of 13 million exchangeable shares of our Canadian subsidiary, which shares will be exchangeable by the holders into shares of our common stock on a 1-to-1 basis;
- The issuance by us to a trustee of shares of our Series A Special Voting Preferred Stock that will entitle the sellers to direct the trustee to vote a number of shares equal to the number of exchangeable shares of our Canadian subsidiary that remain outstanding from time to time on all matters on which our shareholders are entitled to vote;
- Assumption of debt of the entities being acquired by us; and
- Earn-out payments of up to $12 million in the aggregate over a four year period, contingent upon achievement by the acquired business of specified earnings targets in years 2007 through 2010.

In addition, we agreed to make a contingent cash payment following the fifth anniversary of the closing if the average price of our common stock does not equal or exceed $3.076 within any 10 trading days during the five year period following the closing of the purchase transaction.

At signing of the Purchase Agreement, we delivered $5.0 million to the sellers as a deposit against the purchase price payable under the agreement.

On April 19, 2007, we entered into a Mutual Termination and Release Agreement with The Buffalo Group, pursuant to which we and the other parties to the Purchase Agreement mutually agreed to terminate the Purchase Agreement. The parties determined that it was in the mutual best interest of each party to terminate the proposed agreement. Under the terms of the Mutual Termination and Release Agreement, Buffalo agreed to return to us $4,750,000 of the $5,000,000 deposit previously provided by us to The Buffalo Group pursuant to the Purchase Agreement, and the parties have released each other from any claims arising under or related to the Purchase Agreement. We received $4,750,000 in April 2007. The remaining portion of the deposit of $250,000 and other due diligence fees incurred in the acquisition process were recorded as terminated acquisition expenses in the first quarter of 2007.

9. DEBT

Short-term bank borrowings consist of the following:

	JUNE 30, 2007	DECEMBER 31, 2006

Import trade bills payable - DBS Bank and Aurora Capital	$ 6,902,696	$ 5,844,887
Bank direct acceptances - DBS Bank	1,939,870	3,368,054
Other Hong Kong credit facilities - DBS Bank	5,999,369	4,483,241
	$ 14,841,935	$ 13,696,182

Long-term obligations consist of the following:

	JUNE 30, 2007	DECEMBER 31, 2006
Equipment financing	$ 23,555	$ 38,148
Credit facility - Guggenheim, net	11,754,274	11,212,724
Debt facility and factoring agreement - GMAC CF	13,314,353	19,553,755
	25,092,182	30,804,627
Less current portion	(13,337,908)	(19,586,565)
	$ 11,754,274	$ 11,218,062

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

Since March 2003, DBS Bank (Hong Kong) Limited ("DBS") had made available a letter of credit facility of up to HKD 20 million (equivalent to US $2.6 million at June 30, 2007) to our subsidiaries in Hong Kong. This was a demand

facility and was secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman; and by our guarantee. The letter of credit facility was increased to HKD 30 million (equivalent to US $3.9 million) in June 2004. In September 2006, a tax loan for HKD 8.438 million (equivalent to US $1.1 million) was also made available to our Hong Kong subsidiaries and bears interest at the rate equal to the Hong Kong prime rate plus 1% and are subject to the same security. It bore interest at 9% per annum at June 30, 2007. As of June 30, 2007, $374,000 was outstanding under this tax loan.

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS. Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries may borrow under this facility at any time is US $25 million. The interest rate under the letter of credit facility is equal to the Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which the interest rate was 8.5% per annum at June 30, 2007, or the Standard Bills Rate quoted by DBS plus 0.5% if paid in any

other currency, which the interest rate was 8.59% per annum at June 30, 2007. This is a demand facility and is secured by a security interest in all the assets of the Hong Kong subsidiaries; by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez and Todd Kay; and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2006, interest coverage ratio, leverage ratio and limitations on additional indebtedness. We are in the process of revising these covenants for 2007. As of June 30, 2007, $13.9 million was outstanding under this facility. In addition, $7.8 million of open letters of credit were outstanding and $3.3 million was available for future borrowings as of June 30, 2007.

As of June 30, 2007, the total balance outstanding under the DBS Bank credit facilities was $13.9 million (classified above as follows: $6.0 million in import trade bills payable, $1.9 million in bank direct acceptances and $6.0 million in other Hong Kong credit facilities).

From time to time, we open letters of credit under an uncommitted line of credit from Aurora Capital Associates which issues these letters of credits out of Israeli Discount Bank. As of June 30, 2007, $949,000 was outstanding under this facility (classified above under import trade bills payable) and $704,000 of letters of credit was open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

EQUIPMENT FINANCING

We had three equipment loans outstanding at June 30, 2007. One of these equipment loans bore interest at 15.8% payable in installments through 2007. The second loan bears interest at 6.15% payable in installments through 2007 and the third loan bears interest at 4.75% payable in installments through 2008. As of June 30, 2007, $24,000 was outstanding under these loans.

DEBT FACILITY AND FACTORING AGREEMENT - GMAC COMMERCIAL FINANCE

On October 1, 2004, we amended and restated our previously existing credit 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 or (b) $40 million, minus in each case, any amount owed by us to GMAC CF. In May 2005, we amended our factoring agreement with GMAC CF to permit our subsidiaries party thereto and us, to borrow up to the lesser of $3 million or 50% of the value of eligible inventory. In connection with this amendment, we granted GMAC CF a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC CF to increase the amount we might borrow against inventory to the lesser of $5 million or 50% of the value of eligible inventory. The $5 million limit was reduced to $4 million on April 1, 2006.

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

On June 16, 2006, we expanded our credit facility with GMAC CF by entering into a new Loan and Security Agreement and amending and restating our previously existing Factoring Agreement with GMAC CF. UPS Capital Corporation is also a lender under the Loan and Security Agreement. This is a revolving credit facility and has a term of 3 years. The amount we may borrow under this credit facility is determined by a percentage of eligible accounts receivable and inventory, up to a maximum of $55 million, and includes a letter of credit facility of up to $4 million. Interest on outstanding amount under this credit facility is payable monthly and accrues at the rate of the "prime rate" plus 0.5%. Our obligations under the GMAC CF credit facility are secured by a lien on substantially all our domestic assets, including a first priority lien on our accounts receivable and inventory. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness. This facility includes customary default provisions, and all outstanding obligations may become immediately due and payable in the event of a default. The facility bore interest at 8.75% per annum at June 30, 2007. As of June 30, 2007, we were in violation with the EBITDA covenant and a waiver was obtained on August 10, 2007. A total of $13.3 million was outstanding with respect to receivables factored under the GMAC CF facility at June 30, 2007.

CREDIT FACILITY FROM GUGGENHEIM CORPORATE FUNDING LLC AND WARRANTS

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

In connection with Guggenheim credit facility, on June 16, 2006, we issued the lenders under this facility warrants to purchase up to an aggregate of 3,857,143 shares of our common stock. These warrants have a term of 10 years. These warrants are exercisable at a price of $1.88 per share with respect to 20% of the shares, $2.00 per share with respect to 20% of the shares, $3.00 per share with respect to 20% of the shares, $3.75 per share with respect to 20% of the shares and $4.50 per share with respect to 20% of the shares. The exercise prices are subject to adjustment for certain dilutive issuances pursuant to the terms of the warrants. 357,143 shares of the warrants will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and Emerging Issues Task Force ("EITF") No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" and determined to be a derivative instrument due to certain registration

rights. As such, the warrants excluding the ones not exercisable were valued at $4.9 million using the Black-Scholes model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. We also paid to Guggenheim 2.25% of the committed principal amount of the loans which was $563,000 on June 16, 2006. The $563,000 fee paid to Guggenheim is included in the deferred financing cost, and the value of the warrants to purchase 3.5 million shares of our common stock of $4.9 million is recorded as debt discount, both of them are amortized over the life of the loan. For the six months ended June 30, 2007, $604,000 was amortized.

Durham Capital Corporation ("Durham") acted as our advisor in connection with the Guggenheim credit facility. As compensation for its services, we agreed to pay Durham a cash fee in an amount equal to 1% of the committed principal amount of the loans under the Guggenheim credit facility. As a result, $250,000 was paid on June 16, 2006. In addition, we issued Durham a warrant to purchase 77,143 shares of our common stock. This warrant has a term of 10 years and is exercisable at a price of $1.88 per share, subject to adjustment for certain dilutive issuances. 7,143 shares of this warrant will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to

certain registration rights. As such, the warrants excluding the ones not exercisable were valued at $105,000 using the Black-Scholes model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. The $250,000 fee paid to Durham and the value of the warrants to purchase 70,000 shares of our common stock of $105,000 is included in the deferred financing cost, and is amortized over the life of the loan. For the six months ended June 30, 2007, $39,000 was amortized.

The Guggenheim facility bore interest at 11.82% per annum at June 30, 2007. As of June 30, 2007, we were in violation with the EBITDA covenant and a waiver was obtained on August 10, 2007. A total of $11.8 million, net of $3.7 million of debt discount, was outstanding under this facility at June 30, 2007.

As of June 30, 2006, the warrants were being accounted for as a liability pursuant to the provisions of SFAS No. 133 and EITF No. 00-19. This was because we granted the warrant holders certain registration rights that were outside our control. In accordance with SFAS No. 133, the warrants were being valued at each reporting period. Changes in fair value were recorded as adjustment to fair value of derivative in the statements of operations. The outstanding warrants were fair valued on June 16, 2006, the date of the transaction, at $5.0 million and we, in accordance with SFAS No. 133, revaluated the warrants on June 30, 2006 at the closing stock price on June 30, 2006 to $5.2 million; as a result, an expense of $218,000 was recorded as an adjustment to fair value of derivative in the second quarter of 2006 on our consolidated statements of operations. On August 11, 2006, the registration rights agreement relating to the warrants was amended to provide that if we were unable to file or have the registration statement declared effective by the required deadlines,

we would be required to pay the warrant holders cash payments as partial liquidated damages each month until the registration statement was filed and/or declared effective. The liquidated damages payable by us to the warrant holders are limited to 20% of the purchase price of the shares underlying the warrants, which we determined to be a reasonable discount for restricted stock as compared to registered stock. As a result of amending the registration rights relating to the warrants on August 11, 2006, the warrants were reclassified from debt to equity in accordance with EITF No. 00-19 in the third quarter of 2006. The outstanding warrants were revaluated on August 11, 2006 at the closing stock price on August 11, 2006 to $4.5 million; as a result, income of $729,000 was recorded as an adjustment to fair value of derivative in the third quarter of 2006 on our consolidated statements of operations. As such, a net gain of $511,000 was recognized in our statements of operations as an adjustment to fair value of derivative in 2006.

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

The credit facilities with GMAC CF and Guggenheim prohibit us from paying dividends or other distributions on our common stock. In addition, the credit facility with GMAC CF prohibits our subsidiaries that are borrowers under the facility from paying dividends or other distributions to us, and the credit facility with DBS prohibits our Hong Kong facilities from paying any dividends or other distributions or advances to us. We are also restricted in making advances to and borrowing funds from our subsidiaries under the Guggenheim credit facility.

10. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

We use forward currency contracts to manage risks generally associated with foreign exchange rate. During 2006, we entered into foreign currency forward contracts to hedge against the effect of exchange rate fluctuations on cash flows denominated in foreign currencies and certain inter-company financing transactions. At June 30, 2007, we had no open foreign exchange forward contracts. Hedge ineffectiveness resulted in an impact of $196,000 in our consolidated statements of operations in the six months of June 30, 2007.

11. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued

for fiscal years beginning after November 15, 2007. We are required to adopt the provision of SFAS No. 157, as applicable, beginning in fiscal year 2008. We do not believe the adoption of SFAS No. 157 will have a material impact on our financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106 and 132(R)". SFAS No. 158 requires us to (a) recognize a plan's funded status in the statement of financial position, (b) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year and (c) recognize changes in the funded status of a defined postretirement plan in the year in which the changes occur through other comprehensive income. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The adoption of SFAS No. 158 did not have a material impact on our results of operations and financial condition.

In September 2006, the SEC issued SAB No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements", to address diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires the quantification of misstatements based on their impact on both the balance sheet and the income statement to determine materiality. The guidance provides for a one-time cumulative effect adjustment to correct for misstatements that were not deemed material under a company's prior approach but are material under the SAB No. 108 approach. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities- Including an amendment of FASB Statement No. 115". SFAS No. 159 permits entities to choose to measure certain financial assets and liabilities at fair value (the "fair value option"). Unrealized gains and losses, arising subsequent to adoption, are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS No. 159 on our results of operations and financial condition.

12. INCOME TAXES

Our effective tax rate differs from the statutory rate principally due to the following reasons: (1) a substantial 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; and (2) 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 June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment for unrecognized tax benefits but

reduced retained earnings as of January 1, 2007 by approximately $1 million attributable to penalties accrued as a component of income tax payable. As of the date of adoption, our unrecognized tax benefits totaled approximately $8.9 million.

We and several of our subsidiaries file income tax returns in the U.S., Hong Kong, Luxembourg, Mexico and various state jurisdictions. We are currently subject to an IRS audit for the years including 1996 through 2002 but are not being audited for state or non-U.S. income tax examinations for years open in those taxing jurisdictions.

In January 2004, the 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. We are currently at the appellate level of the IRS and believe the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002 will be resolved within the next twelve months and if so, unrecognized tax benefits related to U.S. tax positions may decrease by up to $6.2 million by December 31, 2007. 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 under the caption "Income Taxes". 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.

The total unrecognized tax benefits as of January 1, 2007 were $8.9 million, excluding interest, penalties and related income tax benefits and would be recorded as a component of income tax expense if recognized. We recognize interest accrued related to unrecognized tax benefits and penalties as a component of income tax expense. As of January 1, 2007, the accrued interest and penalties were $8.0 million and $1.2 million, respectively, excluding any related income tax benefits. As of June 30, 2007, the unrecognized tax benefits did not change from the date of adoption.

In many cases, the uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. Federal and state statutes are open from 1996 through the present period. Hong Kong statutes are open from 2001, Luxembourg from 2003 and Mexico from 2001.

13. NET INCOME (LOSS) PER SHARE

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2007	2006	2007	2006
Basic EPS Computation:				
Numerator	$ 809,264	$ 611,284	$ (191,655)	$ 1,447,655
Denominator:				
Weighted average common shares outstanding	30,543,763	30,543,763	30,543,763	30,378,715
Basic EPS	$ 0.03	$ 0.02	$ (0.01)	$ 0.05
Diluted EPS Computation:				
Numerator	$ 809,264	$ 611,284	$ (191,655)	$ 1,447,655
Denominator:				
Weighted average common share outstanding	30,543,763	30,543,763	30,543,763	30,378,715
options	112	657	--	125
Total shares	30,543,875	30,544,420	30,543,763	30,378,840
Diluted EPS	$ 0.03	$ 0.02	$ (0.01)	$ 0.05

Only 112 shares and 657 shares of outstanding options were included in the computation of income per share in the three months ended June 30, 2007 and 2006, respectively, as the exercise prices of the remaining shares were greater than the average market price for the three months ended June 30, 2007 and 2006. Only 125 shares of outstanding options were included in the computation of income per share in the six months ended June 30, 2006, as the exercise prices of the remaining shares were greater than the average market price for the six months ended June 30, 2006. All options were excluded from the computation of net loss per share in the six months ended June 30, 2007 as the impact would be anti-

dilutive. All warrants were excluded from the computation of net income (loss) per share in the three months and six months ended June 30, 2007 and 2006, as the exercise prices of the warrants were greater than the average market price for the three months and six months ended June 30, 2007 and 2006. The following table presents potentially dilutive securities that were not included in the computation of income (loss) per share:

AS OF JUNE 30,

	2007	2006
Options	8,299,659	7,694,034
Warrants	5,931,732	5,931,732
Total	14,231,391	13,625,766

14. RELATED PARTY TRANSACTIONS

As of June 30, 2007, related party affiliates were indebted to us in the amounts of $12.2 million. These include amounts due from Gerard Guez, our Chairman and Interim Chief Executive Officer. From time to time in the past, we had advanced funds to, Mr. Guez. These were net advances to Mr. Guez or payments paid on his behalf before the enactment of the Sarbanes-Oxley Act in 2002. The promissory note documenting these advances contains a provision that the entire amount together with accrued interest is immediately due and payable upon our written demand. The greatest outstanding balance of such advances to Mr. Guez in the second quarter of 2007 was approximately $2,087,000. At June 30, 2007, the entire balance due from Mr. Guez totaling $2.1 million has been shown as reductions to shareholders' equity in the accompanying financial statements. All amounts due from Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was $81,000 and $87,000 for the six months ended June 30, 2007 and 2006, respectively. Mr. Guez paid expenses on our behalf of approximately $162,000 and $132,000 for the six months ended June 30, 2007 and 2006, 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.

Azteca Production International, Inc. ("Azteca") is a corporation owned by the brothers of Gerard Guez, our Chairman and Interim Chief Executive Officer. We purchased $499,000 and $0 of finished goods, fabric and service from Azteca and its affiliates in the six months ended June 30, 2007 and 2006, respectively. Our total sales of fabric and service to Azteca in the six months ended June 30, 2007 and 2006 were $0 and $9,000, respectively.

At June 30, 2007, Messrs. Guez and Kay beneficially owned 488,400 and 1,003,500 shares, respectively, of common stock of Tag-It Pacific, Inc. ("Tag-It"), collectively representing approximately 8.0% of Tag-It's common stock. Tag-It is a provider of brand identity programs to manufacturers and retailers of apparel and accessories. We purchased $140,000 and $202,000 of trim from Tag-It in the six months ended June 30, 2007 and 2006, respectively. Our sales of garment accessories to Tag-It were $76,000 and $0 in the six months ended June 30, 2007 and 2006, respectively.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing Company, LLC ("Seven Licensing") to act as its buying agent to source apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Total sales to Seven Licensing in the six months ended June 30, 2007 were $6.9 million. Net amount due from these related parties as of June 30, 2007 and December 31, 2006 was $8.1 million and $7.5 million, respectively.

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, 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, with payments due 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. As of September 30,

2006, the outstanding balance of the notes and interest receivables was $41.1 million prior to the reserve. Historically, we had placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we had satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, during the third quarter of 2006, the purchasers ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in the third quarter of 2006 in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately $27.1 million, resulting in a notes receivable balance at September 30, 2006 of approximately $14 million. We believe there was no significant change subsequently on the value of the underlying assets securing the notes; therefore, we did not have additional reserve after the third quarter of 2006. We will continue to pursue payments under the notes receivable and believe the remaining $14 million balance at June 30, 2007 is realizable. See Note 6 of the "Notes to Consolidated Financial Statements".

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 did not purchase fabric from Acabados y Terminados in the six months ended June 30, 2007 and 2006. Net amount due from these parties as of June 30, 2007 was $159,000.

We lease our executive offices and warehouse in Los Angeles, California from GET. Additionally, we lease our office space and warehouse in Hong Kong from Lynx International Limited. GET and Lynx International Limited are each owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman. We paid $563,000 and $538,000 in rent in the six months ended June 30, 2007 and 2006, respectively, for office and warehouse facilities. On August 1, 2006, we entered into a lease agreement with GET for the Los Angeles offices and warehouse, which lease has a term of five years with an option to renew for an additional five year term. On February 1, 2007, we entered into a one year lease agreement with Lynx International Limited for our office space and warehouse in Hong Kong.

On May 1, 2006, we sublet a portion of our executive office in Los Angeles, California and our sales office in New York to Seven Licensing Company, LLC for a monthly payment of $25,000 on a month to month basis. Seven Licensing is beneficially owned by Gerard Guez. We received $150,000 and $50,000 in rental

income from this sublease in the six months ended June 30, 2007 and 2006, respectively.

At June 30, 2007, we had various employee receivables totaling $235,000 included in due from related parties.

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

15. COMMITMENTS AND CONTINGENCIES

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 advance in monthly installments during the term of the agreement. The royalty owed to the licensor in excess of the guaranteed minimum, if any, is payable no later than 30 days after the end of the preceding full quarter with the amount for last quarter adjusted based on actual royalties owed for the year. If a portion of the guaranteed minimum royalty is determined not to be recoverable, the unrecoverable portion is charged to expense at that time. At June 30, 2007, the total commitment on royalties remaining on the term was $8.0 million.

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. On July 19, 2005, Camuto Consulting Group replaced J.S. Brand Management as the master licensor. In December 2004, we advanced $2.2 million as payment for the first year's minimum royalties. We applied $1.1 million from the above advance against the royalty and marketing expenses in 2005 and $884,000 in the first three months of 2006. In March 2006, we had written off the capitalized balance of $192,000 and recognized a corresponding loss. The loss was classified as royalty expense on our consolidated statements of operations. In March 2006, we became involved in a dispute with the licensor of the Jessica Simpson brands over our continued rights to these brands. We are presently in litigation with the licensor. See Note 17 of the "Notes to Consolidated Financial Statements". The licensor has refused to accept payments and maintains that the agreement has been terminated. There have been no sales of new products since the licensor started refusing to approve products for manufacture and sale. If we are successful in the lawsuit against the licensor, then we expect to be able to reduce or eliminate these

payment obligations as an offset to damages sustained by us. If we do not succeed in our claims, we believe we will likely not be required to make the entire guaranteed payments contemplated under the agreement. As a result, in 2006 and in the first six months of 2007, we did not accrue for the payments of minimum royalty, sales royalty and advertising commitment of $3.6 million pursuant to the agreement.

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 are no longer 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.

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif; a shareholder at the time of the transaction, with agreement was amended in October 2004. Pursuant to the agreement, as amended, on November 30, 2004, we sold to the purchasers substantially all of our assets and real property in Mexico, including the equipment and facilities we previously leased to Mr. Nacif's affiliates. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, $5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We did not purchase fabric in the six months ended June 30, 2007 and 2006.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing Company, LLC to act as its buying agent to source apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Total sales to Seven Licensing in the six months ended June 30, 2007 were $6.9 million.

16. OPERATIONS BY GEOGRAPHIC AREAS

Our predominant business is the design, distribution and importation of private label and private brand casual apparel. Substantially all of our revenues are from the sales of apparel. We are organized into two geographic regions: the United States and Asia. 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 and Asia is presented below. Inter-company revenues and assets have been eliminated to arrive at the consolidated amounts.

	UNITED STATES	ASIA	ADJUSTMENTS AND ELIMINATIONS	TO
THREE MONTHS ENDED JUNE 30, 2007				
Sales	$ 55,694,000	$ 4,407,000	$ --	$ 60
Inter-company sales	--	36,579,000	(36,579,000)	
Total revenue	$ 55,694,000	$ 40,986,000	$ (36,579,000)	$ 60
Income from operations	$ 774,000	$ 1,755,000	$ --	$ 2
Interest income	$ 41,000	$ 2,000	$ --	$
Interest expense	$ 1,173,000	$ 47,000	$ --	$ 1
Provision for depreciation and amortization	$ 564,000	$ 39,000	$ --	$
Capital expenditures	$ 49,000	$ 135,000	$ --	$
THREE MONTHS ENDED JUNE 30, 2006				
Sales	$ 58,783,000	$ 300,000	$ --	$ 59
Inter-company sales	--	31,573,000	(31,573,000)	
Total revenue	$ 58,783,000	$ 31,873,000	$ (31,573,000)	$ 59
Income from operations	$ 1,462,000	$ 1,147,000	$ --	$ 2
Interest income (1)	$ 480,000	$ 1,000	$ --	$
Interest expense	$ 1,876,000	$ 70,000	$ --	$ 1
Provision for depreciation and amortization	$ 1,382,000	$ 27,000	$ --	$ 1
Capital expenditures	$ 23,000	$ 18,000	$ --	$
SIX MONTHS ENDED JUNE 30, 2007				
Sales	$ 107,791,000	$ 8,416,000	$ --	$ 116
Inter-company sales	--	60,815,000	(60,815,000)	
Total revenue	$ 107,791,000	$ 69,231,000	$ (60,815,000)	$ 116
Income from operations	$ 220,000	$ 2,372,000	$ --	$ 2
Interest income	$ 86,000	$ 2,000	$ --	$

Interest expense	$ 2,473,000	$ 90,000	$ --	$ 2
Provision for depreciation and amortization	$ 1,126,000	$ 62,000	$ --	$ 1
Capital expenditures	$ 114,000	$ 158,000	$ --	$
Total assets (2)	$ 88,543,000	$ 126,168,000	$ (110,404,000)	$ 104
SIX MONTHS ENDED JUNE 30, 2006				
Sales	$ 119,363,000	$ 981,000	$ --	$ 120
Inter-company sales	--	60,924,000	(60,924,000)	
Total revenue	$ 119,363,000	$ 61,905,000	$ (60,924,000)	$ 120
Income from operations	$ 1,944,000	$ 2,311,000	$ --	$ 4
Interest income (3)	$ 965,000	$ 1,000	$ --	$
Interest expense	$ 3,006,000	$ 128,000	$ --	$ 3
Provision for depreciation and amortization	$ 1,728,000	$ 54,000	$ --	$ 1
Capital expenditures	$ 32,000	$ 31,000	$ --	$
Total assets (4)	$ 136,573,000	$ 115,445,000	$ (106,822,000)	$ 145

(1) Interest income in the U.S. included $432,000 interest earned from the notes receivable related to the sale of our fixed assets in Mexico of which notes are recorded in Luxembourg.

(2) Total assets in the U.S. included $15,973,000 from Luxembourg and $7,720,000 from Mexico.

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(3) Interest income in the U.S. included $873,000 interest earned from the notes receivable related to the sale of our fixed assets in Mexico of which notes are recorded in Luxembourg.

(4) Total assets in the U.S. included $41,586,000 from Luxembourg and $8,528,000 from Mexico.

17. LITIGATION

JESSICA SIMPSON & CAMUTO CONSULTING GROUP

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands (captioned Tarrant Apparel Group v. Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson) in the Supreme Court of the State of New York, County of New York. The suit named Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson as defendants, and asserts that the defendants failed to provide promised support in connection with our sublicense agreement for the Jessica Simpson brands, as well as fraud against Camuto Consulting. The complaint was amended to add Vincent Camuto as a defendant and includes nine 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, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto Consulting, a claim against Vincent Camuto individually for fraudulent inducement, and a claim against With You, Inc. and Ms. Simpson that we are an intended third party beneficiary of the license between those defendants and Camuto Consulting. On or about October 30, 2006, Camuto Consulting, VCJS and Vincent Camuto served their answer to the amended complaint, which included a counterclaim against us for breach of the sublicense agreement and alleged damages of no less than $100 million. With You, Inc. and Jessica Simpson also filed counterclaims against us alleging trademark infringement, unfair competition and business practices, violation of the right of privacy and other claims, and seeking injunctive relief and damages in an amount to be determined but no less than $100 million plus treble and punitive damages. By Order filed January 17, 2007, the Court granted the motion of With You, Inc. and Ms. Simpson to discontinue all of Ms. Simpson's counterclaims, and her personal counterclaims were dismissed with prejudice. With You, Inc.'s counterclaims remain. Ms. Simpson and With You, Inc. appealed the trial Court's ruling denying their motion to dismiss the claim against them. The trial Court's determination was affirmed on appeal in a decision dated May 31, 2007. Accordingly, our claim against With You, Inc. and Ms. Simpson remains. On or about February 27, 2007, we served a motion seeking dismissal of two of With You, Inc.'s counterclaims. With You, Inc. did not oppose the motion and by Order dated March 22, 2007, the Court granted our motion, dismissing two of With You, Inc.'s counterclaims. On July 5, 2007, the trial Court denied a motion filed in December 2006 by Camuto Consulting, VCJS and Vincent Camuto to dismiss our claims for declaratory judgment seeking a declaration that the sublicense is exclusive and remains in full force and effect and those aspects of our claims that seek specific performance. Discovery in the matter has been underway since May 2006. We intend to continue vigorously to pursue this action and defend the counterclaims.

BAZAK INTERNATIONAL CORPORATION

Shortly before May 2004, Bazak International Corp. commenced an action against us in the New York County Supreme Court claiming that we breached an oral contract to sell a quantity of close-out goods, as a consequence of which Bazak was damaged to the extent of $1.3 million. Bazak International Corp. claimed that our liability exists under a theory of breach of contract or unjust enrichment. A non-jury trial was held in the United States District Court for the Southern District of New York beginning on November 27, 2006 and ending on February 1, 2007. On June 12, 2007, the Court dismissed the case against us.

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.

TARRANT APPAREL GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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18. SUBSEQUENT EVENTS

On July 19, 2007, our wholly-owned subsidiary, Tarrant Luxembourg S.a.r.l. entered into an amendment to a letter agreement dated March 21, 2007, with Solticio, S.A. de C.V., Inmobiliaria Cuadros, S.A. de C.V., and Acabados y Cortes Textiles, S.A. de C.V., and Tavex Algodonera, S.A. Pursuant to the original letter agreement, Tavex obtained the right and option to pay to Tarrant Luxembourg an aggregate of U.S. $20 million in cash and promissory notes, in full satisfaction of all indebtedness owed to Tarrant Luxembourg from the Sellers, whereupon Tarrant Luxembourg would, among other things, release all liens it has on certain property owned by the Sellers' in Mexico. The amendment:

(i) extended the period during which Tavex may exercise the option from July 19, 2007 until September 1, 2007;

(ii) amended the consideration to be paid by Tavex to Tarrant Luxembourg upon exercise of the option to U.S. $17,750,000 payable in cash concurrently upon exercise of the option; and

(iii) Amended Tarrant Luxembourg's obligation to purchase fabric from Tavex following exercise of the option, reducing the purchase commitment to U.S. $1,250,000 in denim fabric that must be purchased prior to the end of fiscal 2007, and requiring Tarrant Luxembourg to deliver an irrevocable letter of credit for the full purchase price.

See Note 6 of the "Notes to Consolidated Financial Statements" for more information.

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

The following management's discussion and analysis should be read together with the Consolidated Financial Statements of Tarrant Apparel Group and the "Notes to Consolidated Financial Statements" included elsewhere in this Form 10-Q. This discussion summarizes the significant factors affecting the consolidated operating results, financial condition and liquidity and cash flows of Tarrant Apparel Group for the quarterly periods and year to date ended June 30, 2007 and 2006. Except for historical information, the matters discussed in this management's discussion and analysis of financial condition and results of operations are forward looking statements that involve risks and uncertainties and are based upon judgments concerning various factors that are beyond our control. See "Item 1A. Risk Factors" in Part II of this Form 10-Q.

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 retailers, such as Macy's Merchandising Group, Kohl's, New York & Co., Mervyn's, Mothers Work, Chico's, Wal-Mart, Charlotte Russe, the Avenue, Lane Bryant, Sears, and J.C. Penney. Our products are manufactured in a variety of woven and knit fabrications and include jeans wear, casual pants, shorts, skirts, dresses, t-shirts, blouses, shirts and other tops and jackets. Our private brands include American Rag CIE and Alain Weiz.

PRIVATE LABEL

Private label business has been our core competency for over twenty years, and involves a one to one relationship with a large, centrally controlled retailer with whom we can develop product lines that fit with the characteristics of their particular customer. Private label sales in the first six months of 2007 were $96.1 million compared to $89.7 million in the first six months of 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 six months of 2007 were $20.1 million compared to $30.6 million in the first six months of 2006. At June 30, 2007, we owned or licensed rights to the following private brands:

- AMERICAN RAG CIE: During the first quarter of 2005, we extended our agreement with Macy's Merchandising Group through 2014, pursuant to which we exclusively distribute our American Rag CIE brand through Macy's Merchandising Group's national Department Store organization of more than 600 stores. Net sales of American Rag CIE branded apparel totaled $19.8 million in the first six months of 2007 compared to $15.5 million in the first six months of 2006.

- ALAIN WEIZ: We have previously sold Alan Weiz apparel exclusively to Dillard's Department Stores. Net sales of Alain Weiz branded apparel totaled $3.2 million in the first six months of 2006. From January 1, 2007, we may sell our licensed brand "Alain Weiz" to specialty stores and department stores. There were no sales in the first six months of 2007.

- 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 did not have any sales of Jessica Simpson branded apparel after the first quarter of 2006 and do not anticipate any sales unless and until we are able to successfully resolve our dispute and retain our rights to these brands.

THE BUFFALO GROUP

On December 6, 2006, we entered into a definitive stock and asset purchase agreement to acquire certain assets and entities comprising The Buffalo Group. The Buffalo Group designs, imports and sells contemporary branded apparel and accessories, primarily in Canada and the United States.

Pursuant to the purchase agreement, we and our subsidiaries agreed to acquire (1) all the outstanding capital stock of four principal operating subsidiaries of The Buffalo Group - Buffalo Inc., 3163946 Canada Inc., 3681441 Canada Inc. and Buffalo Corporation, and (2) certain assets, consisting primarily of intellectual property rights and licenses, from The Buffalo Trust, for a total aggregate purchase price of up to approximately $120 million. At signing of the purchase agreement, we delivered $5.0 million to the sellers as a deposit against the purchase price payable under the agreement.

On April 19, 2007, we entered into a Mutual Termination and Release Agreement with The Buffalo Group, pursuant to which we and the other parties to the purchase agreement mutually agreed to terminate the purchase agreement. The parties determined that it was in the mutual best interest of each party to terminate the proposed agreement. Under the terms of the Mutual Termination and Release Agreement, Buffalo agreed to return to us $4,750,000 of the $5,000,000 deposit previously provided by us to The Buffalo Group pursuant to the purchase agreement, and the parties have released each other from any claims arising under or related to the purchase agreement. We received $4,750,000 in April 2007. The remaining portion of the deposit of $250,000 and other due diligence fees incurred in the acquisition process were recorded as terminated acquisition expenses in the first quarter of 2007.

NOTES RECEIVABLE - RELATED PARTY RESERVE

In connection with the sale in 2004 of our assets and real property in Mexico, the purchasers of the Mexico assets, Solticio, S.A. de C.V. ("Solticio"), and Acabados y Cortes Textiles, S.A. de C.V. ("Acotex"), issued us unsecured promissory notes of $3,910,000 that mature on November 30, 2007 and secured promissory notes of $40,204,000 with payments due 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. The secured notes are secured by the real and personal property in Mexico that we sold to the purchasers. As of September 30, 2006, the outstanding balance of the notes and interest receivables was $41.1 million prior to the reserve. Historically, we had placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we had satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, during the third quarter of 2006, the purchasers ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in the third quarter of 2006 in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately $27.1 million, resulting in a net notes receivable balance at September 30, 2006 of approximately $14 million. We believe there was no significant change subsequently on the value of the underlying assets securing the notes; therefore, we did not have additional reserve after the third quarter of 2006. We will continue to pursue payment of all amounts under the notes receivable and believe the remaining $14 million balance at June 30, 2007 is realizable.

On March 21, 2007, our wholly-owned subsidiary, Tarrant Luxembourg S.a.r.l., entered into a letter agreement with Solticio, Inmobiliaria Cuadros, S.A. de C.V., and Acotex, (Acotex and together with Solticio and Inmobiliaria, the "Sellers"), and Tavex Algodonera, S.A. On July 19, 2007, the parties amended the letter agreement.

Pursuant to the agreement, as amended, Tavex has the right and option (but not an obligation), at any time on or prior to September 1, 2007, to pay to Tarrant Luxembourg an aggregate of U.S. $17.75 million in cash, whereupon, among other things:

- o Tarrant Luxembourg will terminate the Solticio and Acotex promissory notes described above and release the Sellers from any further obligations thereunder, and terminate and release all liens on the collateral securing those notes;

- o Tarrant Luxembourg and the Sellers will terminate all other executory obligations among the parties, including any obligation of ours to purchase fabric from Solticio and Acotex; and

- o Tarrant Luxembourg would agree to purchase from Tavex at least U.S. $1.25 million of fabric prior to the end of 2007, and Tarrant Luxembourg would deliver a irrevocable letter of credit for the full purchase price.

Tavex is not obligated to exercise the option and the terms and conditions of the letter could change prior to the expiration period. During the option period, we agreed that we would not seek to enforce the Solticio and Acotex promissory notes, including by taking action with respect to the collateral, nor would we enter into any agreement with a third party that would adversely affect Tavex's rights under the agreement.

The Sellers also agreed during the option period, to work exclusively with Tavex in respect of the payment of the Solticio and Acotex promissory notes and the other transactions contemplated by the letter agreement, and not to enter into any agreement with any person other than Tavex with respect to the payment and/or assignment of the Solticio and Acotex promissory notes and the transactions contemplated by the agreement.

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 allowance for returns, discounts and bad debts, inventory, notes receivable - related parties reserve, valuation of long-lived and intangible assets and goodwill, income taxes, stock options valuation, contingencies and litigation. We base our estimates on historical experience and on various assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. In addition, management is periodically faced with uncertainties, the outcomes of

which are not within its control and will not be known for prolonged period of time.

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

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For a further discussion on the application of these and other accounting policies, see Note 1 of the "Notes to Consolidated Financial Statements" included in our Annual Report on Form 10-K for the year ended December 31, 2006.

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 June 30, 2007, the balance in the allowance for returns, discounts and bad debts reserves was $1.9 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:

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

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 June 30, 2007, we have a goodwill balance of $8.6 million, and a net property and equipment balance of $1.5 million.

INCOME TAXES

As part of the process of preparing our consolidated financial statements, we are 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. We record a valuation allowance to reduce our net deferred tax assets to the amount that is more likely than not to be realized. We have considered future taxable income and ongoing tax planning strategies in assessing the need for the valuation allowance. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of operations.

In addition, accruals are also estimated for ongoing audits regarding U.S. Federal tax issues that are currently unresolved, based on our estimate of whether, and the extent to which, additional taxes will be due. We routinely monitor the potential impact of these situations and believe that amounts are properly accrued for. If we ultimately determine that payment of these amounts is unnecessary, we will reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We will record an additional charge in our provision for taxes in any period we determine that the original estimate of a tax liability is less than we expect the ultimate assessment to be.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax

benefit. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment for unrecognized tax benefits but reduced retained earnings as of January 1, 2007 by approximately $1 million attributable to penalties accrued as a component of income tax payable. As of the date of adoption, our unrecognized tax benefits totaled approximately $8.9 million.

We and several of our subsidiaries file income tax returns in the U.S.,

Hong Kong, Luxembourg, Mexico and various state jurisdictions. We are currently subject to an IRS audit for the years including 1996 through 2002 but are not being audited for state or non-U.S. income tax examinations for years open in those taxing jurisdictions.

In January 2004, the 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. We are currently at the appellate level of the IRS and believe the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002 will be resolved within the next twelve months and if so, unrecognized tax benefits related to U.S. tax positions may decrease by up to $6.2 million by December 31, 2007. 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 under the caption "Income Taxes". 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.

The total unrecognized tax benefits as of January 1, 2007 were $8.9 million, excluding interest, penalties and related income tax benefits and would be recorded as a component of income tax expense if recognized. We recognize interest accrued related to unrecognized tax benefits and penalties as a component of income tax expense. As of January 1, 2007, the accrued interest and penalties were $8.0 million and $1.2 million, respectively, excluding any related income tax benefits. As of June 30, 2007, the unrecognized tax benefits did not change from the date of adoption.

In many cases, the uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. Federal and state statutes are open from 1996 through the present period. Hong Kong statutes are open from 2001, Luxembourg from 2003 and Mexico from 2001.

DEBT COVENANTS

Our debt agreements require certain covenants including a minimum level of EBITDA and specified tangible net worth; and required interest coverage ratio and leverage ratio as discussed in Note 9 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, 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. As of June 30, 2007, we were in violation of the EBITDA covenant and waivers of the defaults were obtained in August 2007 from our lenders.

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 11 of the "Notes to Consolidated Financial Statements."

RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED
	2007	2006	2007
Net sales	100.0%	100.0%	100.0%
Cost of sales	79.1	78.6	78.6
Gross profit	20.9	21.4	21.4
Selling and distribution expenses	5.6	4.7	5.8
General and administration expenses	10.4	11.7	11.0
Royalty expenses	0.7	0.6	0.7
Terminated acquisition expenses	--	--	1.7
Income from operations	4.2	4.4	2.2
Interest expense	(2.0)	(3.3)	(2.2)
Interest Income	0.1	0.8	0.1
Interest in income of equity method investee	0.0	0.1	0.1
Other income	0.1	0.2	0.1
Adjustment to fair value of derivative	(0.0)	(0.4)	0.2
Other expense	(0.0)	(0.7)	(0.0)
Income before taxes	2.4	1.1	0.5
Income taxes	1.1	0.1	0.7
Minority interest in consolidated subsidiary	0.0	0.0	0.0
Net income (loss)	1.3%	1.0%	(0.2)%

SECOND QUARTER 2007 COMPARED TO SECOND QUARTER 2006

Net sales increased by $1.0 million, or 1.7%, to $60.1 million in second quarter of 2007 from $59.1 million in the second quarter of 2006. Sales of private label in the second quarter of 2007 were $47.9 million compared to $47.6 million in the same period of 2006. Sales of private brands in the second quarter of 2007 were $12.2 million compared to $11.4 million in the same period of 2006 with the increase resulting primarily from increased sales of American Rag brand to Macy's Merchandising Group in the second quarter of 2007.

Gross profit consists of net sales less product costs, direct labor, duty, quota, freight in, and brokerage, warehouse handling and markdown. Gross

profit decreased by $108,000 to $12.6 million in the second quarter of 2007 from $12.7 million in the second quarter of 2006. As a percentage of net sales, gross profit decreased from 21.4% in the second quarter of 2006 to 20.9% in the second quarter of 2007. The decrease in gross margin in the second quarter of 2007 was due primarily to a greater proportion of sales of lower margin products in the current period.

Selling and distribution expenses increased by $554,000, or 19.8%, to $3.4 million in the second quarter of 2007 from $2.8 million in the second quarter of 2006. As a percentage of net sales, these expenses increased to 5.6% in the second quarter of 2007 from 4.7% in the second quarter of 2006. The increase in selling and distribution expenses was primarily due to overhead related to a new label and increased advertising expenses during the second quarter of 2007.

General and administrative expenses decreased by $663,000, or 9.6%, to $6.2 million in the second quarter of 2007 from $6.9 million in the second quarter of 2006. As a percentage of net sales, these expenses decreased to 10.4% in the second quarter of 2007 from 11.7% in the second quarter of 2006. General and administrative expenses in the second quarter of 2006 included $284,000 of expenses of financing cost paid to the placement agent and the remaining value of the warrants to placement agent and $171,000 of prepayment penalty paid to the debenture holders as a result of the repayment of the debentures in June 2006, as compared to no such expense in second quarter of 2007.

Royalty and marketing allowance expenses increased by $81,000, or 22.9%, to $434,000 in the second quarter of 2007 from $353,000 in the second quarter of 2006. The increase was primarily due to an increase in sales under American Rag brand in the second quarter of 2007. As a percentage of net sales, these expenses increased slightly to 0.7% in the second quarter of 2007 from 0.6% in the second quarter of 2006.

Operating income in the second quarter of 2007 was $2.5 million, or 4.2% of net sales, compared to $2.6 million, or 4.4% of net sales, in the comparable period of 2006, because of the factors discussed above.

Interest expense decreased by $726,000, or 37.3%, to $1.2 million in the second quarter of 2007 from $1.9 million in the second quarter of 2006. As a percentage of net sales, this expense decreased to 2.0% in the second quarter of 2007 from 3.3% in the second quarter of 2006. The decrease in interest expense was primarily due to expensing $711,000 in the second quarter of 2006 of debt discount related to the intrinsic value of the conversion option of debentures and the remaining value of the warrants issued to holders of debentures as a result of the repayment of the debentures in June 2006, compared to no such expenses in the second quarter of 2007. Interest income decreased by $438,000, or 91.1%, to $43,000 in the second quarter of 2007 from $481,000 in the second quarter of 2006. The decrease in interest income was primarily due to the interest earned from the notes receivable related to the sale of our fixed assets in Mexico in the second quarter of 2006, but no such income in the second quarter of 2007.

Interest in income of equity method investee was $43,000 in the second quarter of 2007, compared to $63,000 in the second quarter of 2006. Interest in income of equity method investee represented our 45% share of equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores. Other income was $65,000 in the second quarter of 2007, compared to $91,000 in the second quarter of 2006. Other expense was $9,000 in the second

quarter of 2007, compared to $400,000 in the second quarter of 2006.

Loss allocated to minority interest in the second quarter of 2007 was $1,000, representing the minority partner's share of losses in PBG7. Income allocated to minority interests in the second quarter of 2006 was $7,000.

FIRST SIX MONTHS OF 2007 COMPARED TO FIRST SIX MONTHS OF 2006

Net sales decreased by $4.1 million, or 3.4%, to $116.2 million in the first six months of 2007 from $120.3 million in the first six months of 2006. Sales of private label in the first six months of 2007 were $96.1 million compared to $89.7 million in the same period of 2006, with the increase resulting primarily from increased sales to New York & Co and Seven Licensing, and partially offset by decreased sales to Kohl's in the first six months of 2007. Sales of private brands in the first six months of 2007 were $20.1 million compared to $30.6 million in the same period of 2006. The decline in private brands sales is the result of sales of Alain Weiz, Jessica Simpson and House of Dereon brands in the first six months of 2006, compared to no such sales in the first six months of 2007, and partially offset by an increase in sales of American Rag brand to Macy's Merchandising Group in the first six months of 2007.

Gross profit consists of net sales less product costs, direct labor, duty, quota, freight in, and brokerage, warehouse handling and markdown. Gross profit decreased by $280,000 to $24.9 million in the first six months of 2007 from $25.2 million in the first six months of 2006. The decrease in gross profit occurred primarily because of a decrease in sales. As a percentage of net sales, gross profit increased from 20.9% in the first six months of 2006 to 21.4% in the first six months of 2007. The increase in gross margin in the current period is primarily attributable to the absence of sales from the lower margin House of Dereon and Jessica Simpson brand apparel that were included in the first six months of 2006.

Selling and distribution expenses increased by $1.1 million, or 18.6%, to $6.8 million in the first six months of 2007 from $5.7 million in the first six months of 2006. As a percentage of net sales, these expenses increased from 4.8% for the first six months of 2006 to 5.8% for the first six months of 2007. The increase in selling and distribution expenses was primarily due to overhead related to a new label and increased advertising expenses during the first six months of 2007.

General and administrative expenses decreased by $636,000, or 4.8%, to $12.7 million in the first six months of 2007 from $13.4 million in the first six months of 2006. As a percentage of net sales, these expenses

decreased to 11.0% in the first six months of 2007 from 11.1% in the first six months of 2006. General and administrative expenses in the first six months of 2006 included $284,000 of expenses of financing cost paid to the placement agent and the remaining value of the warrants to placement agent and $171,000 of prepayment penalty paid to the debenture holders as a result of the repayment of the debentures in June 2006, as compared to no such expenses in the first six months of 2007.

Royalty and marketing allowance expenses decreased by $1.0 million, or 56.9%, to $791,000 in the first six months of 2007 from $1.8 million in the first six months of 2006. As a percentage of net sales, these expenses decreased to 0.7% in the first six months of 2007 from 1.5% in the first six months of

2006 due to royalties on sales under the licensed Jessica Simpson and Alain Weiz brands in the first six months of 2006, for which there were no such sales in the first six months of 2007.

Terminated acquisition expenses in the first six months of 2007 were $2 million, or 1.7% of net sales, compared to no such expense in the first six months of 2006. These expenses consisted of the non-refunded portion of a deposit in the amount of $250,000 and other due diligence fees incurred in connection with the proposed acquisition of The Buffalo Group, which transaction was mutually terminated on April 19, 2007.

Operating income for the first six months of 2007 was $2.6 million, or 2.2% of net sales, compared to operating income of $4.3 million, or 3.5% of net sales, in the comparable prior period of 2006 as a result of the factors discussed above.

Interest expense decreased by $571,000 or 18.2%, to $2.6 million in the first six months of 2007 from $3.1 million in the first six months of 2006. As a percentage of net sales, interest expense decreased to 2.2% in the first six months of 2007 from 2.6% in the first six months of 2006. The decrease was primarily due to expensing $711,000 in the six months of 2006 of debt discount related to the intrinsic value of the conversion option of debentures and the remaining value of the warrants issued to holders of debentures as a result of the repayment of the debentures in June 2006, but no such expense in the first six months of 2007. Interest income decreased by $878,000, or 90.9%, to $88,000 in the first six months of 2007 from $966,000 in the first six months of 2006. The decrease in interest income was primarily due to the interest earned from the notes receivable related to the sale of our fixed assets in Mexico in the first six months of 2006, but no such income in the first six months of 2007.

Interest in income of equity method investee was $127,000 in the first six months of 2007, compared to $110,000 in the first six months of 2006. Interest in income of equity method investee represented our 45% share of equity interest in the owner of the trademark "American Rag CIE" and the operator of American Rag retail stores. Other income was $152,000 in the first six months of 2007, compared to $124,000 in the first six months of 2006. Adjustment to fair value of derivative was $196,000 in the first six months of 2007, compared to $(218,000) in the first six months of 2006. Other expense was $11,000 in the first six months of 2007, compared to $400,000 in the first six months of 2006.

Loss allocated to minority interest in the six months of 2007 was $1,000, representing the minority partner's share of losses in PBG7. Loss allocated to minority interest in the first six months of 2006 was $4,000.

LIQUIDITY AND CAPITAL RESOURCES

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

Our liquidity is dependent, in part, on customers paying on time. Any abnormal chargebacks or returns may affect our source of short-term funding. Any

changes in credit terms given to major customers may have an impact on our cash flow. Suppliers' credit is another major source of short-term financing and any adverse changes in their terms will have negative impact on our cash flow.

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

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

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

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

As of June 30, 2007, we had $964,000 in cash and cash equivalents as noted on our consolidated balance sheet and statement of cash flows. This represented an increase of $59,000 or 6.6% compared to a total of $905,000 as of December 31, 2006.

Cash flows for the six months ended June 30, 2007 and 2006 were as follows (dollars in thousands):

CASH FLOWS:	2007	2006
Net cash provided by (used in) operating activities	$ 1,303	$(2,401)
Net cash provided by investing activities	$ 3,859	$ 703
Net cash provided by (used in) financing activities	$(5,103)	$ 1,748

During the first six months of 2007, net cash provided by operating activities was $1.3 million, as compared to net cash used in operating activities of $2.4 million for the same period in 2006. Net cash provided by operating activities in the first six months of 2007 resulted primarily from a net loss of $192,000 and a decrease of accounts payable of $3.7 million offset by depreciation and amortization expense of $1.2 million and a $2.0 million due diligence fees expensed in connection with termination of our proposed acquisition of The Buffalo Group.

During the first six months of 2007, net cash provided by investing activities was $3.9 million, as compared to net cash provided by investing activities of $703,000 for the same period in 2006. Net cash provided by investing activities in the first six months of 2007 resulted primarily from a return of $4.75 million of deposit offset by approximately $700,000 of due diligence fees incurred in connection with previously proposed acquisition of The Buffalo Group.

During the first six months of 2007, net cash used in financing

activities was $5.1 million, as compared to net cash provided by financing activities of $1.7 million for the same period in 2006. Net cash used in financing activities in the first six months of 2007 resulted primarily from pay down of $6.2 million of our long-term bank borrowings offset by $1.1 million net proceeds from our short-term bank borrowings.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

Following is a summary of our contractual obligations and commercial commitments available to us as of June 30, 2007 (in millions):

	PAYMENTS DUE BY PERIOD				
CONTRACTUAL OBLIGATIONS	Total	Less than 1 year	Between 2-3 years	Between 4-5 years	After 5 year
Long-term debt (1)	$ 36.3	$ 16.3	$ 3.7	$ 16.3	$ --
Operating leases	8.5	1.7	2.6	2.1	2
Minimum royalties (2)	14.1	6.9	2.0	2.7	2
Purchase commitment	45.4	12.9	10.0	10.0	12
Total Contractual Cash Obligations	$ 104.3	$ 37.8	$ 18.3	$ 31.1	$ 17

(1) Includes interest on long-term debt obligations. Based on outstanding borrowings as of June 30, 2007, 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 $7.5 million.

(2) Includes minimum royalties of $6.1 million under the agreement with the licensor of the Jessica Simpson brands.

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

Since March 2003, DBS Bank (Hong Kong) Limited had made available a letter of credit facility of up to HKD 20 million (equivalent to US $2.6 million at June 30, 2007) to our subsidiaries in Hong Kong. This was a demand facility and was secured by the pledge of our office property, which is owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman; and by our guarantee. The letter of credit facility was increased to HKD 30 million (equivalent to US $3.9 million) in June 2004. In September 2006,

a tax loan for HKD 8.438 million (equivalent to US $1.1 million) was also made available to our Hong Kong subsidiaries and bears interest at the rate equal to the Hong Kong prime rate plus 1% and are subject to the same security. It bore interest at 9% per annum at June 30, 2007. As of June 30, 2007, $374,000 was outstanding under this tax loan.

In June 2006, our subsidiaries in Hong Kong, Tarrant Company Limited, Marble Limited and Trade Link Holdings Limited, entered into a new credit facility with DBS. Under this facility, we may arrange for letters of credit and acceptances. The maximum amount our Hong Kong subsidiaries may borrow under this facility at any time is US $25 million. The interest rate under the letter of credit facility is equal to the Standard Bills Rate quoted by DBS minus 0.5% if paid in Hong Kong Dollars, which the interest rate was 8.5% per annum at June 30, 2007, or the Standard Bills Rate quoted by DBS plus 0.5% if paid in any other currency, which the interest rate was 8.59% per annum at June 30, 2007. This is a demand facility and is secured by a security interest in all the assets of the Hong Kong subsidiaries; by a pledge of our office property where our Hong Kong office is located, which is owned by Gerard Guez and Todd Kay; and by our guarantee. The DBS facility includes customary default provisions. In addition, we are subject to certain restrictive covenants, including that we maintain a specified tangible net worth, and a minimum level of EBITDA at December 31, 2006, interest coverage ratio, leverage ratio and limitations on additional indebtedness. We are in the process of revising these covenants for 2007. As of June 30, 2007, $13.9 million was outstanding under this facility. In addition, $7.8 million of open letters of credit were outstanding and $3.3 million was available for future borrowings as of June 30, 2007.

On October 1, 2004, we amended and restated our previously existing credit facility with GMAC Commercial Finance LLC 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 or (b) $40 million, minus in each case, any amount owed by us to GMAC CF. In May 2005, we amended our factoring agreement with GMAC CF to permit our subsidiaries party thereto and us, to borrow up to the lesser of $3 million or 50% of the value of eligible inventory. In connection with this amendment, we granted GMAC CF a lien on certain of our inventory located in the United States. On January 23, 2006, we further amended our factoring agreement with GMAC CF to increase the amount we might borrow against inventory to the lesser of $5 million or 50% of the value of eligible inventory. The $5 million limit was reduced to $4 million on April 1, 2006.

On June 16, 2006, we expanded our credit facility with GMAC CF by entering into a new Loan and Security Agreement and amending and restating our previously existing Factoring Agreement with GMAC CF. UPS Capital Corporation is also a lender under the Loan and Security Agreement. This is a revolving credit facility and has a term of 3 years. The amount we may borrow under this credit facility is determined by a percentage of eligible accounts receivable and

inventory, up to a maximum of $55 million, and includes a letter of credit facility of up to $4 million. Interest on outstanding amount under this credit facility is payable monthly and accrues at the rate of the "prime rate" plus 0.5%. Our obligations under the GMAC CF credit facility are secured by a lien on substantially all our domestic assets, including a first priority lien on our accounts receivable and inventory. This credit facility contains customary financial covenants, including covenants that we maintain minimum levels of EBITDA and interest coverage ratios and limitations on additional indebtedness. This facility includes customary default provisions, and all outstanding obligations may become immediately due and payable in the event of a default. The facility bore interest at 8.75% per annum at June 30, 2007. As of June 30, 2007, we were in violation with the EBITDA covenant and a waiver was obtained on August 10, 2007. A total of $13.3 million was outstanding with respect to receivables factored under the GMAC CF facility at June 30, 2007.

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

In connection with Guggenheim credit facility, on June 16, 2006, we issued the lenders under this facility warrants to purchase up to an aggregate of 3,857,143 shares of our common stock. These warrants have a term of 10 years. These warrants are exercisable at a price of $1.88 per share with respect to 20% of the shares, $2.00 per share with respect to 20% of the shares, $3.00 per share with respect to 20% of the shares, $3.75 per share with respect to 20% of the shares and $4.50 per share with respect to 20% of the shares. The exercise prices are subject to adjustment for certain dilutive issuances pursuant to the terms of the warrants. 357,143 shares of the warrants will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF No. 00-19, "Accounting for Derivative Financial

Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at $4.9 million using the Black-Scholes model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. We also paid to Guggenheim 2.25% of the committed principal amount of the loans which was $563,000 on June 16, 2006. The $563,000 fee paid to Guggenheim is included in the deferred financing cost, and the value of the warrants to purchase 3.5 million shares of our common stock of $4.9 million is recorded as debt discount, both of them are amortized over the life of the loan. For the six months ended June 30, 2007, $604,000 was amortized.

Durham Capital Corporation acted as our advisor in connection with the Guggenheim credit facility. As compensation for its services, we agreed to pay Durham a cash fee in an amount equal to 1% of the committed principal amount of the loans under the Guggenheim credit facility. As a result, $250,000 was paid on June 16, 2006. In addition, we issued Durham a warrant to purchase 77,143 shares of our common stock. This warrant has a term of 10 years and is exercisable at a price of $1.88 per share, subject to adjustment for certain dilutive issuances. 7,143 shares of this warrant will not become exercisable unless and until a specified portion of the initial term loan is actually funded by the lenders. The warrants were evaluated under SFAS No. 133 and EITF 00-19 and determined to be a derivative instrument due to certain registration rights. As such, the warrants excluding the ones not exercisable were valued at $105,000 using the Black-Scholes model with the following assumptions: risk-free interest rate of 5.1%; dividend yields of 0%; volatility factors of the expected market price of our common stock of 0.70; and contractual term of ten years. The $250,000 fee paid to Durham and the value of the warrants to purchase 70,000 shares of our common stock of $105,000 is included in the deferred financing cost, and is amortized over the life of the loan. For the six months ended June 30, 2007, $39,000 was amortized.

The Guggenheim facility bore interest at 11.82% per annum at June 30, 2007. As of June 30, 2007, we were in violation with the EBITDA covenant and a waiver was obtained on August 10, 2007. A total of $11.8 million, net of $3.7 million of debt discount, was outstanding under this facility at June 30, 2007.

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

The credit facilities with GMAC CF and Guggenheim prohibit us from paying dividends or other distributions on our common stock. In addition, the credit facility with GMAC CF prohibits our subsidiaries that are borrowers under the facility from paying dividends or other distributions to us, and the credit facility with DBS prohibits our Hong Kong facilities from paying any dividends or other distributions or advances to us. We are also restricted in making advances to and borrowing funds from our subsidiaries under the Guggenheim credit facility.

We had three equipment loans outstanding at June 30, 2007. One of these equipment loans bore interest at 15.8% payable in installments through 2007. The second loan bears interest at 6.15% payable in installments through 2007 and the

third loan bears interest at 4.75% payable in installments through 2008. As of June 30, 2007, $24,000 was outstanding under the three 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 June 30, 2007, $949,000 was outstanding under this facility and $704,000 of letters of credit was open under this arrangement. We pay a commission fee of 2.25% on all letters of credits issued under this arrangement.

We have financed our operations from our cash flow from operations, borrowings under our bank and other credit facilities, issuance of long-term debt, and sales of equity and debt securities. 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.

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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.

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. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. We are currently at the appellate level of the IRS and believe the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002 will be resolved within the next twelve months and if so, unrecognized tax benefits related to U.S. tax positions may decrease by up to $6.2 million by December 31, 2007. 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 under the caption "Income Taxes". 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.

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 and warehouse in Los Angeles, California from GET. Additionally, we leased office space and warehouse in Hong Kong from Lynx International Limited. GET and Lynx International Limited are each owned by Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman. We believe, at the time the leases were entered into, the rents on these properties were comparable to then prevailing market rents. We paid $563,000 and $538,000 in rent in the six months ended June 30, 2007 and 2006, respectively, for office and warehouse facilities. On August 1, 2006, we entered

into a lease agreement with GET for the Los Angeles offices and warehouse, which lease has a term of five years with an option to renew for an additional five year term. On February 1, 2007, we entered into a one year lease agreement with Lynx International Limited for our office space and warehouse in Hong Kong.

On May 1, 2006, we sublet a portion of our executive office in Los Angeles, California and our sales office in New York to Seven Licensing Company, LLC for a monthly payment of $25,000 on a month to month basis. Seven Licensing is beneficially owned by Gerard Guez. We received $150,000 and $50,000 in rental income from this sublease in the six months ended June 30, 2007 and 2006, respectively.

In August 2004, we entered into an Agreement for Purchase of Assets with affiliates of Mr. Kamel Nacif, a shareholder at the time of the transaction, 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, with payments due 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. As of September 30, 2006, the outstanding balance of the notes and interest receivables was $41.1 million prior to the reserve. Historically, we had placed orders for purchases of fabric from the purchasers pursuant to the purchase commitment agreement we entered into at the time of the sale of the Mexico assets, and we had satisfied our payment obligations for the fabric by offsetting the amounts payable against the amounts due to us under the notes. However, during the third quarter of 2006, the purchasers ceased providing fabric and are not currently making payments under the notes. We further evaluated the recoverability of the notes receivable and recorded a loss on the notes receivable in the third quarter of 2006 in an amount equal to the outstanding balance less the value of the underlying assets securing the notes. The loss was estimated to be approximately $27.1 million,

resulting in a notes receivable balance at September 30, 2006 of approximately $14 million. We believe there was no significant change subsequently on the value of the underlying assets securing the notes; therefore, we did not have additional reserve after the third quarter of 2006. We will continue to pursue payments under the notes receivable and believe the remaining $14 million balance at June 30, 2007 is realizable. Upon consummation of the sale, we entered into a purchase commitment agreement with the purchasers, pursuant to which we have agreed to purchase annually over the ten-year term of the agreement, $5 million of fabric manufactured at our former facilities acquired by the purchasers at negotiated market prices. We did not purchase fabric from Acabados y Terminados in the six months ended June 30, 2007 and 2006. Net amount due from these parties as of June 30, 2007 was $159,000. See Note 6 of the "Notes to Consolidated Financial Statements".

From time to time in the past, we had advanced funds to Mr. Guez. These were net advances to Mr. Guez or payments paid on his behalf before the enactment of the Sarbanes-Oxley Act in 2002. The promissory note documenting these advances contains a provision that the entire amount together with accrued interest is immediately due and payable upon our written demand. The greatest outstanding balance of such advances to Mr. Guez in the second quarter of 2007

was approximately $2,087,000. At June 30, 2007, the entire balance due from Mr. Guez totaling $2.1 million is payable on demand and has been shown as reductions to shareholders' equity in the accompanying financial statements. All amounts due from Mr. Guez bore interest at the rate of 7.75% during the period. Total interest paid by Mr. Guez was $81,000 and $87,000 for the six months ended June 30, 2007 and 2006, respectively. Mr. Guez paid expenses on our behalf of approximately $162,000 and $132,000 for the six months ended June 30, 2007 and 2006, 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.

Azteca Production International, Inc. is a corporation owned by the brothers of Gerard Guez, our Chairman and Interim Chief Executive Officer. We purchased $499,000 and $0 of finished goods, fabric and service from Azteca and its affiliates in the six months ended June 30, 2007 and 2006, respectively. Our total sales of fabric and service to Azteca in the six months ended June 30, 2007 and 2006 were $0 and $9,000, respectively.

On September 1, 2006, our subsidiary in Hong Kong, Tarrant Company Limited, entered into an agreement with Seven Licensing Company, LLC to act as its buying agent to source apparel merchandise. Seven Licensing is beneficially owned by Gerard Guez. Total sales to Seven Licensing in the six months ended June 30, 2007 were $6.9 million. Net amount due from these related parties as of June 30, 2007 and December 31, 2006 was $8.1 million and $7.5 million, respectively.

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.

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. At June 30, 2007, we had no open foreign exchange forward contracts. We do not utilize derivative financial instruments for trading or other speculative purposes. We actively evaluate the creditworthiness of the financial institutions that are counter parties to derivative financial instruments, and we do not expect any counter parties to fail to meet their obligations.

INTEREST RATE RISK. Because our obligations under our various credit agreements bear interest at floating rates, we are sensitive to changes in prevailing interest rates. Any major increase or decrease in market interest

rates that affect our financial instruments would have a material impact on earning or cash flows during the next fiscal year.

Our interest expense is sensitive to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect interest paid on our debt. A majority of our credit facilities are at variable rates. As of June 30, 2007, we had $973,000 of fixed-rate borrowings and $42.7 million of variable-rate borrowings outstanding. A one percentage point increase in interest rates would result in an annualized increase to interest expense of approximately $0.4 million on our variable-rate borrowings.

ITEM 4. CONTROLS AND PROCEDURES.

EVALUATION OF CONTROLS AND PROCEDURES

Members of the our management, including our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures, as defined by paragraph (e) of Exchange Act Rules 13a-15 or 15d-15, as of June 30, 2007, 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 second quarter of 2007 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

During the second quarter ended June 30, 2007, there were no changes in our internal control over financial accounting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

SARBANES-OXLEY ACT OF 2002 SECTION 404 COMPLIANCE

In 2003, we began our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"), which requires detailed review, documentation and testing of our internal controls over financial reporting. This detailed review, documentation and testing includes an assessment of the risks that could adversely affect the timely and accurate preparation of our financial statements and the identification of internal controls that are currently in place to mitigate the risks of untimely or inaccurate preparation of these financial statements. We will be required to include a report on management's assessment of internal controls over financial reporting in our annual report on Form 10-K for the fiscal year ended December 31, 2007.

At the end of 2008, our independent registered public accountants will be required to audit management's assessment. We are in the process of performing the system and process documentation, evaluation and testing required for management to make this assessment and for its independent registered public accountants to provide their attestation report. We have not completed this process or its assessment, and this process will require significant amounts of management time and resources. In the course of evaluation and testing, management may identify deficiencies that will need to be addressed and remediated. We have invested significant internal resources and time in the SOX 404 compliance process, and we believe that we are on schedule to comply with SOX 404.

PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

On or about April 6, 2006, we commenced an action against the licensor of the Jessica Simpson brands (captioned Tarrant Apparel Group v. Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson) in the Supreme Court of the State of New York, County of New York. The suit named Camuto Consulting Group, Inc., VCJS LLC, With You, Inc. and Jessica Simpson as defendants, and asserts that the defendants failed to provide promised support in connection with our sublicense agreement for the Jessica Simpson brands, as well as fraud against Camuto Consulting. The complaint was amended to add Vincent Camuto as a defendant and includes nine 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, breach of the duty of good faith and fair dealing and fraudulent inducement against Camuto Consulting, a claim against Vincent Camuto individually for fraudulent inducement, and a claim against With You, Inc. and Ms. Simpson that we are an intended third party beneficiary of the license between those defendants and Camuto Consulting. On or about October 30, 2006, Camuto Consulting, VCJS and Vincent Camuto served their answer to the amended complaint, which included a counterclaim against us for breach of the sublicense agreement and alleged damages of no less than $100 million. With You, Inc. and Jessica Simpson also filed counterclaims against us alleging trademark infringement, unfair competition and business practices, violation of the right of privacy and other claims, and seeking injunctive relief and damages in an amount to be determined but no less than $100 million plus treble and punitive damages. By Order filed January 17, 2007, the Court granted the motion of With You, Inc. and Ms. Simpson to discontinue all of Ms. Simpson's counterclaims, and her personal counterclaims were dismissed with prejudice. With You, Inc.'s counterclaims remain. Ms. Simpson and With You, Inc. appealed the trial Court's ruling denying their motion to dismiss the claim against them. The trial Court's determination was affirmed on appeal in a decision dated May 31, 2007. Accordingly, our claim against With You, Inc. and Ms. Simpson remains. On or about February 27, 2007, we served a motion seeking dismissal of two of With You, Inc.'s counterclaims. With You, Inc. did not oppose the motion and by Order dated March 22, 2007, the Court granted our motion, dismissing two of With You, Inc.'s counterclaims. On July 5, 2007, the trial Court denied a motion filed in December 2006 by Camuto Consulting, VCJS and Vincent Camuto to dismiss our claims for declaratory judgment seeking a declaration that the sublicense is exclusive and remains in full force and effect and those aspects of our claims that seek specific performance. Discovery in the matter has been underway since May 2006. We intend to continue vigorously to pursue this action and defend the counterclaims.

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

ITEM 1A. RISK FACTORS.

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

RISKS RELATED TO OUR BUSINESS

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

Three customers accounted for approximately 45% of our net sales in first six months of 2007. 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 except for Macy's Merchandising Group for American Rag CIE. 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.

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

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

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

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

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

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

WE DEPEND ON OUR COMPUTER AND COMMUNICATIONS SYSTEMS.

As a multi-national corporation, we rely on our computer and communication network to operate efficiently. Any interruption of this service

from power loss, telecommunications failure, weather, natural disasters or any similar event could have a material adverse affect on our business and operations. Additionally, hackers and computer viruses have disrupted operations at many major companies. We may be vulnerable to similar acts of sabotage, which could have a material adverse effect on our business and operations.

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. In 2006, quota was temporarily reinstated for China until 2008 for certain import merchandise categories. Such disruptions and the temporary measures 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 customers. The failure to make timely deliveries may cause our customers to cancel orders, refuse to accept deliveries, impose non-compliance charges through invoice deductions or other charge-backs, demand reduced prices or reduce future orders, any of which could harm our sales, reputation and overall profitability. We do not have material long-term contracts with any of our independent contractors and any of these contractors may unilaterally terminate their relationship with us at any time. To the extent we are not able to secure or maintain relationships with independent contractors that are able to fulfill our requirements, our business would be harmed.

We have implemented 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 BUSINESS IS SUBJECT TO RISKS OF OPERATING IN A FOREIGN COUNTRY AND TRADE RESTRICTIONS.

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

RISK ASSOCIATED WITH OUR INDUSTRY

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

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

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

OUR BUSINESS IS SUBJECT TO SEASONAL TRENDS.

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

OTHER RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK

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

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. In addition, in July 2004, the IRS initiated an examination of our Federal income tax return for the year ended December 31, 2002. We are currently at the appellate level of the IRS and believe the proposed adjustments made to our federal income tax returns for the years ended 1996 through 2002 will be resolved within the next twelve months and if so, unrecognized tax benefits related to U.S. tax positions may decrease by up to

$6.2 million by December 31, 2007. 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 under the caption "Income Taxes". 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.

THE REQUIREMENTS OF THE SARBANES-OXLEY ACT, INCLUDING SECTION 404, ARE BURDENSOME, AND OUR FAILURE TO COMPLY WITH THEM COULD HAVE A MATERIAL ADVERSE AFFECT ON OUR BUSINESS AND STOCK PRICE.

Effective internal control over financial reporting is necessary for us to provide reliable financial reports and effectively prevent fraud. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate and report on our internal control over financial reporting beginning with our annual report on Form 10-K for the fiscal year ending December 31, 2007. Our independent registered public accounting firm will need to annually attest to our evaluation, and issue their own opinion on our internal control over financial reporting beginning with our annual report on Form 10-K for the fiscal year ending December 31, 2008. We are preparing for compliance with Section 404 by strengthening, assessing and testing our system of internal control over financial reporting to provide the basis for our report. The process of strengthening our internal control over financial reporting and complying with Section 404 is expensive and time consuming, and requires significant management attention. We cannot be certain that the measures we will undertake will ensure that we will maintain adequate controls over our financial processes and reporting in the future. Failure to implement required controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting

obligations. If we or our auditors discover a material weakness in our internal control over financial reporting, the disclosure of that fact, even if the weakness is quickly remedied, could diminish investors' confidence in our financial statements and harm our stock price. In addition, non-compliance with Section 404 could subject us to a variety of administrative sanctions, including the suspension of trading, ineligibility for listing on NASDAQ or one of the national securities exchanges, and the inability of registered broker-dealers to make a market in our common stock, which would further reduce our stock price.

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

As of August 10, 2007, our executive officers and directors and their affiliates owned approximately 43% of our common stock. Gerard Guez, our Chairman and Interim Chief Executive Officer, and Todd Kay, our Vice Chairman, alone own approximately 33% and 8%, respectively, of our common stock at August 10, 2007. Accordingly, our executive officers and directors have the ability to affect the outcome of, or exert considerable influence over, all matters requiring shareholder approval, including the election and removal of directors and any change in control. This concentration of ownership of our common stock could have the effect of delaying or preventing a change of control of us or otherwise discouraging or preventing a potential acquirer from attempting to obtain control of us. This, in turn, could have a negative effect on the market price of our common stock. It could also prevent our shareholders from realizing a premium over the market prices for their shares of common stock.

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

Our shareholders rights plan, our ability to issue additional shares of preferred stock and some provisions of our articles of incorporation and bylaws could make it more difficult for a third party to make an unsolicited takeover attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price without approval of our board of directors.

OUR STOCK PRICE HAS BEEN VOLATILE.

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

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

ABSENCE OF DIVIDENDS COULD REDUCE OUR ATTRACTIVENESS TO YOU.

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

ITEM 6. EXHIBITS.

Exhibit Number	Description
2.1.2	Mutual Termination and Release Agreement, dated April 19, 2007, by and among Tarrant Apparel Group, 4366883 Canada Inc., 3681441 Canada Inc., Buffalo Inc., 3163946 Canada Inc., Buffalo Corporation, BFL Management Inc. in its capacity as the sole trustee of The Buffalo Trust and each stockholder of Target Companies. (Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on April 20, 2007.)
10.19.2	Amendment No. 2 to Loan and Security Agreement, dated May 9, 2007, by and among GMAC Commercial Finance LLC, the Lenders signatory thereto, Tarrant Apparel Group, Fashion Resource (TCL), Inc., Tag Mex, Inc., and Private Brands, Inc.
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.

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: August 13, 2007

By: /s/ David Burke

David Burke,
Chief Financial Officer

Date: August 13, 2007

By: /s/ Gerard Guez

Gerard Guez,
Interim Chief Executive Officer