

AMERICAN APPAREL, INC  
Form 10-Q  
November 10, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**

**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2008

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 No. 001-32697

**American Apparel, Inc.**

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(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**20-3200601**  
(I.R.S. Employer  
Identification No.)

**747 Warehouse Street, Los Angeles, California 90021**

(Address of Principal Executive Offices) (Zip Code)

**Registrant's telephone number, including area code: (213) 488-0226**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. 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  (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common stock, \$0.0001 par value 70,787,280 shares outstanding on November 3, 2008.

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Unless the context requires otherwise, all references in this report to the Company, Registrant, we, our, and us refer to American Apparel, Inc., a Delaware corporation, together with its wholly owned subsidiary, American Apparel (USA), LLC, and its other direct and indirect subsidiaries.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the documents incorporated by reference herein, contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements for purposes of these provisions. Statements that include the use of terminology such as may, will, expects, believes, plans, estimates, potential, or continue, or the negative thereof or other and similar expressions are forward-looking statements. In addition, in some cases, you can identify forward-looking statements by words or phrases such as trend, potential, opportunity, believe, comfortable, expect, anticipate, current, intention, estimate, position, assume, outlook, maintain, sustain, seek, achieve, and similar expressions.

Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focuses and plans and other characterizations of future events or circumstances, including statements expressing general expectations or beliefs, whether positive or negative about future operating results or the development of our products and any statement of assumptions underlying any of the foregoing are forward-looking statements. Forward-looking statements in this report may include, without limitation, statements about:

future financial conditions and operating results;

our plan to make continued investments in advertising and marketing;

our growth, expansion and acquisition prospects and strategies, the success of such strategies and the benefits we believe can be derived from such strategies;

the outcome of litigation matters;

our intellectual property rights and those of others, including actual or potential competitors;

our personnel, consultants and collaborators;

operations outside the United States;

current and future economical and political conditions;

overall industry and market performance;

the impact of accounting pronouncements;

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management's goals and plans for future operations and

other assumptions described in this Quarterly Report on Form 10-Q underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements, which are qualified in their entirety by this cautionary statement. Forward-looking statements are subject to numerous assumptions, events, risks, uncertainties and other factors, including those that may be outside of our control and that change over time. As a result, actual results and/or the timing of events could differ materially from those expressed in or implied by the forward-looking statements and future results could differ materially from historical performance. Such assumptions, events, risks, uncertainties and other factors include, among others, those described in the Company's Annual Report on Form 10-K and Amendments 1 and 2 thereto for the year ended December 31, 2007 (filed with the United States Securities and Exchange Commission (the "SEC") on March 17, 2008, March 28, 2008 and April 29, 2008) as well as in other reports and documents we file with the SEC and include without limitation the following:

changes in the level of consumer spending or preferences or demand for our products;

increasing competition;

our ability to hire and retain key personnel and our relationship with our employees;

suitable store locations and our ability to attract customers to our stores;

effectiveness in carrying out and managing our growth strategy;

failure to maintain the value and image of our brand and protect our intellectual property rights;

declines in comparable store sales;

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seasonality;

consequences of our significant indebtedness, including our ability to comply with our debt agreements and generate cash flow to service our debt and refinance or extend our existing debt.

costs of materials and labor;

location of our facilities in the same geographic area;

manufacturing, supply or distribution difficulties or disruptions;

risks of financial nonperformance by customers;

investigations, enforcement actions and litigation;

compliance with or changes in laws and regulations;

costs as a result of operating as a public company;

material weaknesses in internal controls;

interest rate and foreign currency risks;

loss of U.S. import protections or changes in duties, tariffs and quotas and other risks associated with international business;

our ability to upgrade our information technology infrastructure and other risks associated with the systems that operate our online retail operations; and

general economic and industry conditions, including worsening U.S. and foreign economic conditions and turmoil in the financial markets.

All forward-looking statements included in this document are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any forward-looking statements, except as required by law.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****AMERICAN APPAREL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except per share amounts)

|   | September 30, 2008<br>(unaudited) | December 31,<br>2007 |
|---|-----------------------------------|----------------------|
| <b>ASSETS</b>   |                                   |                      |
| <b>CURRENT ASSETS</b>   |                                   |                      |
| Cash  | \$ 13,889                         | \$ 19,292            |
| Trade accounts receivable, net of allowances of \$1,293 and \$1,876 at September 30, 2008 and December 31, 2007, respectively | 19,941                            | 16,602               |
| Other receivables   | 1,813                             | 1,120                |
| Prepaid expenses and other current assets   | 6,555                             | 4,498                |
| Inventories, net  | 153,537                           | 106,434              |
| Deferred taxes, current portion   | 5,659                             | 4,894                |
| <b>Total Current Assets</b>   | <b>201,394</b>                    | <b>152,840</b>       |
| <b>PROPERTY AND EQUIPMENT, net</b>  | <b>104,179</b>                    | <b>64,868</b>        |
| <b>INTANGIBLE ASSETS, net</b>   | <b>4,088</b>                      | <b>2,286</b>         |
| <b>GOODWILL</b>   | <b>1,906</b>                      | <b>950</b>           |
| <b>DEFERRED TAXES</b>   | <b>5,489</b>                      | <b>3,146</b>         |
| <b>OTHER ASSETS</b>   | <b>11,983</b>                     | <b>9,260</b>         |
| <b>TOTAL ASSETS</b>   | <b>\$ 329,039</b>                 | <b>\$ 233,350</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                   |                      |
| <b>CURRENT LIABILITIES</b>  |                                   |                      |
| Cash overdraft  | \$ 4,191                          | \$ 2,778             |
| Current portion of long-term debt   | 101,527                           | 99,930               |
| Accounts payable  | 35,576                            | 15,451               |
| Accrued expenses  | 22,155                            | 21,877               |
| Income taxes payable  | 6,321                             | 7,300                |
| Current portion of capital lease obligations  | 2,393                             | 3,384                |
| <b>Total Current Liabilities</b>  | <b>172,163</b>                    | <b>150,720</b>       |
| <b>LONG-TERM DEBT, net of current portion</b>   | <b>485</b>                        | <b>642</b>           |
| <b>SUBORDINATED NOTES PAYABLE TO RELATED PARTIES</b>  | <b>5,923</b>                      | <b>6,036</b>         |
| <b>CAPITAL LEASE OBLIGATIONS, net of current portion</b>  | <b>2,239</b>                      | <b>4,066</b>         |
| <b>DEFERRED RENT</b>  | <b>15,531</b>                     | <b>10,065</b>        |
| <b>TOTAL LIABILITIES</b>  | <b>196,341</b>                    | <b>171,529</b>       |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                                   |                      |
| <b>STOCKHOLDERS EQUITY</b>  |                                   |                      |

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|   |                   |                   |
|---|-------------------|-------------------|
| Preferred stock, \$.0001 par value, authorized 1,000 shares; none issued  |                   |                   |
| Common stock, \$.0001 par value, authorized 120,000 shares; 72,220 issued and 70,787 outstanding at September 30, 2008 and 57,595 issued and outstanding at December 31, 2007 | 7                 | 6                 |
| Additional paid-in capital  | 130,231           | 57,162            |
| Accumulated other comprehensive (loss) income   | (1,512)           | 865               |
| Retained earnings   | 14,016            | 3,788             |
|   | 142,742           | 61,821            |
| Less: Treasury stock, 1,433 shares at cost  | (10,044)          |                   |
| <b>TOTAL STOCKHOLDERS EQUITY</b>  | <b>132,698</b>    | <b>61,821</b>     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>  | <b>\$ 329,039</b> | <b>\$ 233,350</b> |

*See accompanying notes to condensed consolidated financial statements.*



**Table of Contents****AMERICAN APPAREL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(amounts in thousands, except per share amounts)

(unaudited)

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2008 | September 30,<br>2007 | September 30,<br>2008 | September 30,<br>2007 |
| <b>NET SALES</b>  | \$ 154,801            | \$ 106,620            | \$ 399,406            | \$ 275,853            |
| <b>COST OF SALES</b> (including share-based compensation of \$12,102 for the three and nine ended September 30, 2008)   | 77,179                | 47,760                | 180,965               | 120,435               |
| <b>GROSS PROFIT</b>   | 77,622                | 58,860                | 218,441               | 155,418               |
| <b>OPERATING EXPENSES</b> (including share-based compensation of \$432 for the nine months ended September 30, 2008 and related party charges of \$155 and \$1,111 for the three months ended September 30, 2008 and 2007, respectively, and \$464 and \$3,217 for the nine months ended September 30, 2008 and 2007, respectively) | 70,780                | 47,148                | 191,606               | 124,932               |
| <b>INCOME FROM OPERATIONS</b>   | 6,842                 | 11,712                | 26,835                | 30,486                |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b>  |                       |                       |                       |                       |
| Interest expense (including related party interest expense of \$90 and \$479 for the three months ended September 30, 2008 and 2007, respectively, and \$271 and \$1,291 for the nine months ended September 30, 2008 and 2007, respectively)   | 3,237                 | 4,397                 | 10,274                | 13,149                |
| Foreign currency transaction loss (gain)  | 1,049                 | (271)                 | 1,047                 | 453                   |
| Other (income) expense  | (636)                 | (539)                 | 133                   | (1,081)               |
| <b>TOTAL INTEREST AND OTHER (INCOME) EXPENSE</b>  | 3,650                 | 3,587                 | 11,454                | 12,521                |
| <b>INCOME BEFORE INCOME TAXES</b>   | 3,192                 | 8,125                 | 15,381                | 17,965                |
| <b>INCOME TAX PROVISION</b>   | 859                   | 2,118                 | 5,153                 | 5,482                 |
| <b>NET INCOME</b>   | \$ 2,333              | \$ 6,007              | \$ 10,228             | \$ 12,483             |
| Weighted average basic shares outstanding   | 70,257                | 48,390                | 69,055                | 48,390                |
| Weighted average diluted shares outstanding   | 70,257                | 48,390                | 70,157                | 48,390                |
| Basic earnings per share  | \$ .03                | \$ .12                | \$ .15                | \$ .26                |
| Diluted earnings per share  | \$ .03                | \$ .12                | \$ .15                | \$ .26                |
| <b>PRO FORMA COMPUTATION RELATED TO CONVERSION TO C CORPORATION FOR INCOME TAX PURPOSES</b>   |                       |                       |                       |                       |
| Historical income before income taxes   |                       | \$ 8,125              |                       | \$ 17,965             |
| Pro forma provision for income taxes  |                       | 3,097                 |                       | 6,848                 |
| Pro forma net income  |                       | \$ 5,028              |                       | \$ 11,117             |
| Pro forma basic earnings per share  |                       | \$ .10                |                       | \$ .23                |
| Pro forma diluted earnings per share  |                       | \$ .10                |                       | \$ .23                |

*See accompanying notes to condensed consolidated financial statements.*



**Table of Contents****AMERICAN APPAREL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands, except per share amounts)

(unaudited)

|  | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2008</b>                                | <b>2007</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                |  |             |
| Cash received from customers                               | \$ 394,833                                 | \$ 279,126  |
| Cash paid to suppliers, employees and others               | (375,380)                                  | (272,614)   |
| Interest paid  | (9,813)                                    | (12,847)    |
| Income taxes paid  | (8,787)                                    | (2,718)     |
| Other  | 7  | 266         |
| Net cash provided by (used in) operating activities        | 860  | (8,787)     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                |  |             |
| Capital expenditures                                       | (52,074)                                   | (11,709)    |
| Purchase of net assets under business acquisition          | (3,500)                                    |             |
| Net cash used in investing activities                      | (55,574)                                   | (11,709)    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                |  |             |
| Cash overdraft from financial institution, net             | 1,429                                      | 1,453       |
| Borrowings (payments) under revolving credit facility, net | 1,788                                      | (696)       |
| Distributions to stockholders                              |  | (4,522)     |
| Advances to stockholders, net                              |  | (214)       |
| Proceeds from exercise of warrants                         | 65,619                                     |             |
| Repurchase of treasury shares                              | (10,044)                                   |             |
| Repurchase of common shares                                | (5,174)                                    |             |
| Payment of loan closing costs                              |  | (1,630)     |
| Payment of merger related costs                            |  | (549)       |
| Borrowings under notes payable to related parties          |  | 478         |
| Borrowings under notes payable to unrelated parties        | 944  | 1,932       |
| Repayments under notes payable to unrelated parties        | (1,224)                                    | (1,178)     |
| Repayment of subordinated note payable to unrelated party  |  | (14,201)    |
| Borrowings under term loans and notes payable              |  | 51,346      |
| Repayment of term loans and notes payable                  |  | (7,709)     |
| Repayment of capital lease obligations                     | (3,102)                                    | (1,211)     |
| Net cash provided by financing activities                  | 50,236                                     | 23,299      |
| <b>EFFECT OF EXCHANGE RATE ON CASH</b>                     | (925)                                      | 267         |
| <b>NET CHANGE IN CASH</b>                                  | (5,403)                                    | 3,070       |
| <b>CASH, beginning of period</b>                           | 19,292                                     | 3,780       |
| <b>CASH, end of period</b>                                 | \$ 13,889                                  | \$ 6,850    |

**RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES**

|  |           |            |
|--|-----------|------------|
| Net income   | \$ 10,228 | \$ 12,483  |
| Depreciation and amortization  | 14,314    | 9,302      |
| Share based compensation   | 12,625    |            |
| Foreign exchange transaction loss (gain)                             | 1,047     | (20)       |
| Loss on disposal of fixed assets and impairment charge               | 219       | 42         |
| Imputed interest on stockholder loans                                |           | 443        |
| Deferred rent  | 5,585     | 1,056      |
| Bad debt expense   | 201       | (329)      |
| Deferred taxes   | (3,132)   |            |
| Increase (decrease) in cash due to changes in assets and liabilities |           |            |
| Trade accounts receivable  | (4,182)   | (4,855)    |
| Other receivables  | (358)     | (502)      |
| Inventories  | (48,367)  | (13,501)   |
| Prepaid expenses and other current assets                            | (2,288)   | (1,314)    |
| Other assets   | (5,459)   | (2,674)    |
| Accounts payable   | 19,847    | (16,699)   |
| Accrued expenses   | 1,081     | 5,003      |
| Income taxes payable   | (501)     | 2,778      |
| Net cash provided by (used in) in operating activities               | \$ 860    | \$ (8,787) |

**NON-CASH INVESTING AND FINANCING ACTIVITIES**

|  |        |          |
|--|--------|----------|
| Property and equipment acquired under a capital lease        | \$ 419 | \$ 1,889 |
| Reclassification of accrued Directors compensation to equity | 432    |          |
| Issuance of common stock to employees and consultants        | 7,020  |          |

*See accompanying notes to condensed consolidated financial statements.*

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**AMERICAN APPAREL, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007**

**(Amounts in thousands, except per share amounts)**

**(unaudited)**

**Note 1. Organization and Business**

American Apparel, Inc., a Delaware corporation, was incorporated in Delaware on July 22, 2005, as Endeavor Acquisition Corp. (the Registrant), a blank check company formed to acquire an operating business. On December 21, 2005, the Registrant consummated its initial public offering (Offering), and on December 18, 2006, entered into an Agreement and Plan of Reorganization (the Acquisition Agreement) with American Apparel, Inc., a California corporation (Old American Apparel), and its affiliated companies.

On November 6, 2007, the Registrant entered into an amended Acquisition Agreement (the Amended Acquisition Agreement). The Registrant consummated the acquisition of Old American Apparel and its affiliated companies on December 12, 2007 (the Acquisition or Merger). Pursuant to the Amended Acquisition Agreement, Old American Apparel and its affiliates, American Apparel Canada Wholesale Inc. and American Apparel Canada Retail Inc., (the affiliates are collectively referred to as the CI Companies) became wholly owned subsidiaries of the Registrant. Upon the completion of the Merger, the Registrant changed its name to American Apparel, Inc. Old American Apparel and the CI Companies are collectively referred to as American Apparel Companies and the consolidated entity, including the Registrant, is collectively referred to as the Company. For accounting purposes, this business combination has been treated as a reverse merger.

The Company is a vertically integrated manufacturer, distributor, and retailer of branded fashion basic apparel. The Company sells product direct to consumers through retail stores which are located both in the United States and internationally, and through an online retail e-commerce website. The Company also operates a wholesale business that sells high quality T-shirts and other casual wear to distributors and screen printers.

On May 9, 2008, the Company completed an asset purchase with an unrelated third party to assume a lease and purchase all of the assets of a fabric dyeing and finishing plant.

**Note 2. Completed Merger and Accounting Treatment of the Merger**

Dov Charney, a 50% owner of Old American Apparel's common stock and 100% owner of the CI Companies' common stock and current Chief Executive Officer (CEO) of the Company received from the Registrant 37,258 shares of the Registrant's common stock in exchange for his ownership interest in Old American Apparel and the CI Companies. The other 50% owner of Old American Apparel's common stock, Sang Ho Lim, received \$67,903 for his ownership interest, the equivalent of 11,132 shares of the Registrant's common stock.

Immediately prior to the closing of the Merger (the Closing), the Registrant had 19,933 shares of common stock outstanding with a net tangible book value of \$121,589, net of \$5,494 of transaction costs. The net tangible book value consisted of cash of \$123,000, a tax liability of \$1,406 and accrued expenses of \$5. The net cash proceeds were used as follows: \$67,903 was paid to Sang Ho Lim for his ownership interest, \$15,764 was paid to Dov Charney and Sang Ho Lim as a Company distribution to settle their estimated personal income tax liabilities as a result of Old American Apparel's subchapter S Corporation status, \$13,323 was used to repay related party and third party debt, and \$26,010 was available for working capital.

At the Closing, 8,064 shares of the Registrant's common stock issued to Dov Charney were placed in escrow until the later of (a) December 12, 2008, the date of the first anniversary of the Closing and (b) the thirtieth day after the date that the Registrant files its Annual Report on Form 10-K for the year ended December 31, 2007 (which report was filed on March 17, 2008), as a fund for the payment of indemnification claims that may be made by the Registrant as a result of any breaches of Old American Apparel's covenants, representations and warranties in the Amended Agreement and certain lawsuits to which Old American Apparel is a party.

Dov Charney agreed not to sell any shares of the Registrant's common stock he received in the Merger before the third anniversary of the Closing, subject to certain exceptions.

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Pursuant to the Amended Acquisition Agreement, the Registrant and Dov Charney entered into a registration rights agreement to provide Dov Charney certain rights relating to the registration of shares of the Registrant's common stock that he received in connection with the Merger. Under the registration rights agreement, Dov Charney is afforded both demand and piggy-back registration rights.

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### *Basis of Presentation*

The Merger has been accounted for as a reverse merger and recapitalization, since the majority stockholder of American Apparel Companies owns a majority of the outstanding shares of the common stock of the Registrant immediately following the completion of the Merger. American Apparel Companies was the accounting acquirer and, consequently, the Merger was treated as a recapitalization of American Apparel Companies. Accordingly, the assets and liabilities and the historical operations that are reflected in these consolidated financial statements for dates and periods prior to December 12, 2007, are those of American Apparel Companies and are recorded at the historical cost basis of American Apparel Companies. The Registrant's assets and liabilities were consolidated as of December 12, 2007 and were recorded at their net tangible book value; the Registrant's results of operations were consolidated with American Apparel Companies commencing December 12, 2007.

Additionally, Old American Apparel and the CI Companies have been under common control since each of the entities' inception. In conjunction with the Merger, the three entities were consolidated in a manner similar to a pooling of interests. Accordingly, Old American Apparel and the CI Companies were consolidated retroactively to January 1, 2005, using the historical cost basis of each entity.

The stockholders' equity section, in addition to reflecting the common control merger retroactive to January 1, 2005, the recapitalization of the number of shares of common stock attributable to the American Apparel Companies stockholders is also reflected retroactive to January 1, 2005. Accordingly, the number of shares presented as outstanding as of January 1, 2005 total 48,390, consisting of the 37,258 issued to Dov Charney, and the 11,132 equivalent number of shares assigned to Sang Ho Lim. Sang Ho Lim's shares were determined by dividing the \$67,903 he received in cash by the \$6.10 net tangible book value per share of the Registrant as of the Closing. These shares were also used to calculate the earnings (loss) per share for all periods prior to the Merger.

The accompanying condensed consolidated financial statements for the three and nine months ended September 30, 2008 and 2007, are unaudited except for the balance sheet information at December 31, 2007, which is derived from the audited consolidated financial statements filed on March 17, 2008, in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. These statements have been prepared in accordance with generally accepted accounting principles in the United States of America (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 GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

The Company has made a number of estimates and assumptions relating to the assets and liabilities, the disclosure of contingent assets and liabilities and the reporting of revenues and expenses to prepare these financial statements in conformity with GAAP. Actual results could differ from those estimates.

The Company experiences seasonality in its operations, and, accordingly, the results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for any other quarter or for the full year. Historically, sales during the second and third fiscal quarters have generally been the highest, with sales during the first fiscal quarter the lowest. This reflects the combined impact of the seasonality of the wholesale and retail segments. Generally, the Company's retail segment has not experienced the same pronounced sales seasonality as other retailers.

### **Note 3. Summary of Significant Accounting Policies and Other Disclosures**

#### *Liquidity Matters*

Over the past years, the Company's growth has been funded through a combination of borrowings from related and unrelated parties, bank debt, lease financing, and more recently by the proceeds received from the exercise of warrants. In January 2007, the Company completed a \$41,000 secured debt financing from a private investment firm. During July 2007, the Company executed an agreement to obtain an additional \$10,000 in financing from a private investment firm. The Company also replaced its revolving credit facility of \$62,500 with an increased revolving facility of \$75,000 from a new lender.

As a result of the Merger, the Company repaid \$13,323 of related party and third party debt and generated \$26,010 of working capital. The Company received proceeds subsequent to December 31, 2007, from the exercise of warrants aggregating \$65,619.

As of September 30, 2008, the Company had approximately \$13,889 in unrestricted cash and \$7,092 available under its revolving credit line. The outstanding balances were \$49,249 under the revolving credit line and \$51,000 under the private investment firm loan (the SOF Loan) as of

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September 30, 2008. The SOF Loan is due January 18, 2009. The revolving credit line is due on the earlier of July 2, 2012 or December 19, 2008, the date thirty days prior to the due date of the SOF Loan, unless the SOF Loan is renewed under terms acceptable to the revolving credit line lenders. Accordingly, the aggregate outstanding balance of \$100,249 from the SOF Loan and the revolving credit line are classified as current liabilities as of September 30, 2008.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50,000 for the fiscal year ending December 31, 2008. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the Eighth Amendment ) with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74,000. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings.

The Company is evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement, which currently matures on January 18, 2009. If by December 19, 2008 the Company is unable to extend or renew the SOF Credit Agreement, or refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, all outstanding obligations under the LaSalle Credit Agreement will become due on December 19, 2008. If acceleration of debt obligations were to occur, we cannot be assured that we would be able to obtain alternative financing or that our assets would be sufficient to repay in full our obligations under our debt instruments. The acceleration of any or all amounts due under the SOF loan or other credit facilities could have a material adverse impact on our operations which could result in the need for the Company to modify its current business plan, curtail operations or affect the Company's ability to continue operations as a going concern.



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The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result should the Company not continue as a going concern.

### *Principles of Consolidation*

The consolidated financial statements include the accounts of American Apparel, Inc. and its direct and indirect wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated upon consolidation.

### *Reclassifications*

Certain reclassifications have been made to prior period amounts to conform to the current year's presentation. The Company reclassified foreign currency (gain) loss in the amount of \$(29) and \$472 for the three and nine months ended September 30, 2007, respectively, from cost of sales to foreign currency transaction (gain) loss. The reclassification resulted in a \$29 increase to cost of sales and an increase to foreign currency transaction (gain) loss as previously reported for the three months ended September 30, 2007. The reclassification also resulted in a \$472 decrease to cost of sales and an increase to foreign currency transaction (gain) loss as previously reported for the nine months ended September 30, 2007. The reclassification did not have any impact on net income or cash flow from operating activities in 2007.

### *Accounting for Warrants*

On December 21, 2005, the Registrant sold 15,000 units ( Units ) in the Offering at \$8.00 per Unit. On January 5, 2006, the Registrant sold an additional 1,161 Units pursuant to the underwriters' over-allotment option. Each Unit consisted of one share of the Registrant's common stock, and one Redeemable Common Stock Purchase Warrant ( Warrant ). Each Warrant entitled the holder to purchase from the Registrant one share of common stock at an exercise price of \$6.00 commencing the later of the completion of the Merger or December 15, 2006, and expiring on December 14, 2009. The Warrants were redeemable by the Registrant, at a price of \$.01 per Warrant upon 30 days' notice after the Warrants become exercisable, only in the event that the last sale price of the common stock was at least \$11.50 per share for any 20 trading days within a 30 trading day period ending on the third day prior to the date on which notice of redemption is given. Such notice of redemption was given on February 6, 2008 (see below).

In connection with this Offering, the Registrant issued an option to the representative of the underwriter to purchase 350 Units at an exercise price of \$10.00 per Unit (the Underwriters Purchase Option ). The Underwriters Purchase Option was exercised in December 2007 in a cashless conversion, resulting in the issuance of 204 shares of common stock and 204 Warrants. Additionally, 200 Warrants were exercised in December 2007, resulting in aggregate proceeds of \$1,200. As a result, as of December 31, 2007, there were 16,165 Warrants outstanding, all with an exercise price of \$6.00 per share.

On February 6, 2008, the Registrant called for redemption of all of its issued and outstanding Warrants. Prior to the redemption date of March 7, 2008, 16,153 of the 16,165 Warrants outstanding at December 31, 2007 were exercised, generating net proceeds to the Registrant of \$65,619. The remaining 12 Warrants were redeemed by the Registrant at a price of \$.01 per Warrant. The Registrant issued 13,521 shares of common stock in connection with the redemption of the Warrants.

### *Stock Repurchase*

On May 23, 2008, the Registrant's Board of Directors authorized a common stock repurchase program that allows the Registrant to repurchase up to an aggregate of \$25,000 of the Registrant's outstanding common stock through open market and privately negotiated transactions based on prevailing market conditions and other factors. At September 30, 2008, the Registrant had repurchased 1,433 shares of the Registrant's common stock for \$10,001 at a weighted average price of \$6.98 per share, plus brokerage commissions of \$43, leaving \$14,999 remaining under the program. All of the shares repurchased have been recorded as treasury stock.

**Table of Contents***Comprehensive Income*

In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 130, Reporting Comprehensive Income, the Company is required to display comprehensive income and its components as part of its complete set of financial statements. Comprehensive income represents the change in stockholders' equity resulting from transactions other than stockholder investments and distributions. Included in accumulated other comprehensive income are changes in equity that are excluded from the Company's net income, specifically, unrealized gains and losses on foreign currency translation adjustments.

Comprehensive income consists of net income and foreign currency translation adjustments. A reconciliation of comprehensive income for the three and nine months ended September 30, 2008 and 2007 is as follows:

|  | Three Months Ended September 30 |          | Nine Months Ended September 30 |           |
|--|---------------------------------|----------|--------------------------------|-----------|
|  | 2008                            | 2007     | 2008                           | 2007      |
| Net income                               | \$ 2,333                        | \$ 6,007 | \$ 10,228                      | \$ 12,483 |
| Foreign currency translation adjustments | (2,927)                         | 419      | (2,377)                        | 496       |
| Total comprehensive income (loss)        | \$ (594)                        | \$ 6,426 | \$ 7,851                       | \$ 12,979 |

*Earnings Per Share*

The Company presents earnings per share ( EPS ) in accordance with SFAS No. 128, Earnings Per Share. SFAS No. 128 requires dual presentation of basic and diluted EPS. Basic EPS includes no dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The effect of the Merger has been given retroactive application in the EPS calculation (Note 2). The common stock issued and outstanding with respect to the pre-Merger stockholders of the Registrant has been included in the EPS calculation since the Closing date of the Merger. All of the Registrant's issued Warrants, including shares of common stock and warrants issued pursuant to the Underwriter's Purchase Option, are reflected in the diluted EPS calculation, using the treasury stock method, commencing with the Closing date of the Merger.

The following provides a reconciliation of information used in calculating EPS:

|   | Three Months Ended September 30 |        | Nine Months Ended September 30 |        |
|---|---------------------------------|--------|--------------------------------|--------|
|   | 2008                            | 2007   | 2008                           | 2007   |
| Weighted average shares outstanding used in basic EPS | 70,257                          | 48,390 | 69,055                         | 48,390 |
| Dilutive effect of Warrants                           |                                 |        | 1,102                          |        |
| Weighted average shares outstanding for diluted EPS   | 70,257                          | 48,390 | 70,157                         | 48,390 |

*Share-Based Compensation*

On December 12, 2007, the stockholders approved the 2007 Performance Equity Plan (the 2007 Plan ). The 2007 Plan authorizes the granting of a variety of incentive awards, the exercise or vesting of which would allow up to an aggregate of 7,710 shares of the Company's common stock to be acquired by the holders of such awards. The purpose of the 2007 Plan is to enable the Company to offer its employees, officers, directors and consultants whose past, present and/or potential contributions to the Company has been, are or will be important to the success of the Company, an opportunity to acquire a proprietary interest in the Company. The 2007 Plan provides for various types of incentive awards including, but not limited to: incentive stock options, non-qualifying stock options, reload stock options, restricted stock and stock appreciation rights. The 2007 Plan enables the compensation committee to exercise its discretion to determine virtually all terms of each grant, which allows the Company to respond to changes in compensation practices, tax laws, accounting regulations and the size and diversity of its business.

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Pursuant to the 2007 Plan, the Company's seven non-employee directors each received a stock grant (of fully vested shares) following the Closing of the Merger and will receive a stock grant for each year of service thereafter, equal to the number of shares of the Company's common stock having an aggregate market value of \$75 at the date of grant. The initial stock grant was approved

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by the Board on February 6, 2008, subject to the filing and effectiveness of a registration statement on Form S-8, which was filed on April 17, 2008. Pursuant to the Board authorization for the initial stock grant, however, the number of shares awarded to the non-employee directors was to be determined using the highest closing price as of December 12, 2007, February 6, 2008 and April 17, 2008. Consequently, the Company issued to each non-employee director approximately 5 shares of common stock, based upon the December 12, 2007 closing price per share of \$15.60. The compensation expense associated with the share awards is approximately \$432 and is reflected in operating expenses for the nine months ended September 30, 2008 in the condensed consolidated financial statements, and was based upon the February 6, 2008 closing price of \$12.85 per share.

On August 14, 2008, 1,851 shares of the Company's common stock (fully vested and not subject to any restrictions or conditions) having an aggregate value of \$12,102 were awarded to eligible manufacturing employees and included in cost of sales for the three and nine months ended September 30, 2008. Of the \$12,102, approximately \$5,174 was withheld for the payment of employment and withholding taxes and 1,058 shares with an aggregate value of \$6,922 were issued to employees and cash in the amount of \$6 was paid to employees in lieu of the issuance of fractional shares. The net share settlement is deemed to be a repurchase by the Company of its common stock. The value of the stock award was determined based upon the August 14, 2008 closing price per share of \$6.54. As of September 30, 2008, the Company has not granted any stock awards under the 2007 Plan, other than to manufacturing employees (Note 10) and non-employee directors. As of September 30, 2008, 5,825 shares of the Company's common stock are available for future grants under the 2007 Plan.

In accordance with SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R) all stock-based compensation must be recognized as an expense in the financial statements and that cost be measured at the fair value of the award. SFAS No. 123R also requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows instead of operating cash inflows.

*Revenue Recognition*

The Company recognizes product sales revenue when title and risk of loss have transferred to the customer, there is persuasive evidence of an arrangement, shipment and passage of title has occurred, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue from wholesale product sales is recorded at the time the product is shipped to the customer. Revenue from online product sales is recorded at the time the product is delivered to the customers. With respect to its retail store operations, the Company recognizes revenue upon the sale of its products to retail customers. The Company's net sales represent gross sales invoiced to customers, less certain related charges for discounts, returns, and other promotional allowances, and is recorded net of sales or value added tax. Allowances provided for these items are presented in the condensed consolidated financial statements primarily as reductions to sales and cost of sales.

*Gift Cards, Gift Certificates and Store Credits*

The Company recognizes the sales from gift cards, gift certificates and store credits as they are redeemed for merchandise. Prior to redemption, the Company maintains an unearned revenue liability for gift cards, gift certificates and store credits until the Company is released from such liability. The Company's gift cards, gift certificates and store credits do not have expiration dates. The unearned revenue for gift cards, gift certificates and store credits are recorded in accrued expenses in the amount of \$1,776 and \$1,816 at September 30, 2008 and December 31, 2007, respectively.

*Foreign Currency Forward Exchange Contracts*

The Company follows the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, which require the recognition of every derivative instrument in the balance sheet as either an asset or liability measured at its fair value. Changes in the fair value of derivatives are to be recorded each period in comprehensive income, if the derivative is designated and effective as part of a hedge accounting transaction, or in earnings if the derivative does not qualify for hedge accounting. The Company's foreign currency forward exchange contracts do not qualify for hedge accounting and, accordingly, adjustments to fair value are recorded in earnings.

The Company enters into forward contracts to mitigate the cash and income statement impact of fluctuations in foreign currencies. At September 30, 2008, the Company's Canadian and German subsidiaries held forward exchange contracts in aggregate amounts of \$1,300 and \$2,250, respectively, to hedge forecasted purchases of inventory in U.S. dollars through May 31, 2009 and December 31, 2008, respectively. At September 30, 2008, net gains on forward foreign exchange contracts, representing the fair value of the contracts using quoted market rates, amounted to approximately \$202, primarily related to the Canadian Dollar and Euro forward contracts, and were recorded in earnings and other assets in the condensed consolidated financial statements.



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### *Taxes*

As a result of the Merger, Old American Apparel was required to convert from a S corporation to a C corporation. As a Subchapter S corporation, U.S. federal and certain state income taxes were the responsibility of the Company's stockholders. Accordingly, these income taxes were not reflected in the Company's financial statements for periods prior to December 12, 2007.

The result of this conversion was to recognize deferred tax assets and liabilities from the expected tax consequences of temporary differences between the book and tax basis of the Company's assets and liabilities at the date of conversion into a taxable entity. This resulted in a deferred tax benefit of \$6,205 being recognized as of December 12, 2007.

The Company's foreign domiciled subsidiaries are subject to foreign income taxes on earnings in their respective jurisdictions. The Company elected to have its foreign subsidiaries, except CI Companies, consolidated in their U.S. federal income tax return; the Company will generally be eligible to receive tax credits on its U.S. federal income tax return for most of the foreign taxes paid.

The unaudited pro forma computation of income tax included in the Condensed Consolidated Statements of Income, represents the tax effects that would have been reported had the Company been subject to U.S. federal and state income taxes as a C Corporation for the three and nine months ended September 30, 2007. Pro forma taxes are based upon the statutory income tax rates and adjustments to income for estimated permanent differences occurring during the period. Actual rates and expenses could have differed had the Company actually been subject to U.S. federal and state income taxes for the periods presented. Therefore, the unaudited pro forma amounts are for informational purposes only and are intended to be indicative of the results of operations had the Company been subject to U.S. federal and state income taxes as a C Corporation for the periods presented.

### *Advertising, Promotion and Catalog*

The Company expenses the production costs of advertising the first time the advertising takes place. The advertising expenses amounted to \$5,474 and \$3,634 for the three months ended September 30, 2008 and 2007, respectively and \$14,646 and \$8,272 for the nine months ended September 30, 2008 and 2007, respectively, and were included in Operating Expenses in the Condensed Consolidated Statements of Income. The Company has cooperative advertising arrangements with certain vendors in its U.S. wholesale segment. For the three months ended September 30, 2008 and 2007, cooperative advertising expenses were \$31 and \$143, respectively. For the nine months ended September 30, 2008 and 2007, cooperative advertising expenses were \$258 and \$364, respectively.

### *Shipping and Handling Costs*

The Company incurs shipping and handling costs in its operations and accounts for such costs in accordance with EITF issue 00-10 Accounting for Shipping and Handling Fees and Costs. These costs consist primarily of freight expenses incurred for third-party shippers to transport products to its retail stores and distribution centers and to its wholesale and online retail customers. These costs are included in Cost of Sales and amounts billed to customers are included in Net Sales in the Condensed Consolidated Statements of Income.

### *Accounting Pronouncements-Newly Issued and Adopted*

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157 Fair Value Measurements, (SFAS No. 157) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company has implemented SFAS No. 157 and has determined that the results did not have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 (SFAS No. 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company has implemented SFAS No. 159 and has determined that the results did not have a material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations (SFAS No. 141R), which replaces SFAS No. 141, Business Combinations. SFAS No. 141R establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including noncontrolling interests, contingent consideration, and certain acquired contingencies. SFAS No. 141R also requires acquisition-related transaction expenses and restructuring costs be expensed as incurred

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rather than capitalized as a component of the business combination. SFAS No. 141R will be applicable prospectively to business combinations for which the acquisition date is on or after January 1, 2009. SFAS No. 141R would have an impact on accounting for any businesses acquired after the effective date of this pronouncement.

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In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – An Amendment of ARB No. 51 (SFAS No. 160)*. SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary (previously referred to as minority interests). SFAS No. 160 also requires that a retained noncontrolling interest upon the deconsolidation of a subsidiary be initially measured at its fair value. Upon effectiveness of SFAS No. 160, the Company would be required to report any noncontrolling interests as a separate component of consolidated stockholders' equity. The Company would also be required to present any net income allocable to noncontrolling interests and net income attributable to the stockholders of the Company separately in its consolidated statements of operations. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after January 1, 2009. SFAS No. 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS No. 160 shall be applied prospectively. SFAS No. 160 would have an impact on the presentation and disclosure of the noncontrolling interests of any non wholly-owned businesses acquired in the future.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Hedging Instruments and Hedging Activities* – an amendment of FASB Statement No. 133 (SFAS No. 161). SFAS No. 161, which is effective January 1, 2009, requires enhanced qualitative and quantitative disclosures with respect to derivatives and hedging activities. The Company does not anticipate SFAS No. 161 to have a material impact on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position SFAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, *Business Combinations*, and other U.S. GAAP principles. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP SFAS 142-3 is effective January 1, 2009, and is not expected to have a material the impact on the Company's consolidated financial statements.

There are no other recently issued accounting pronouncements that are expected to have a material impact on the Company's consolidated financial statements.

**Note 4. Inventories, net**

The components of inventories are as follows:

|   | September 30, 2008 | December 31, 2007 |
|---|--------------------|-------------------|
| Raw materials   | \$ 45,155          | \$ 27,703         |
| Work in process                                       | 1,360              | 3,238             |
| Finished goods  | 111,160            | 80,842            |
|   | 157,675            | 111,783           |
| Less reserve for inventory shrinkage and obsolescence | (4,138)            | (5,349)           |
| Total, net of reserves                                | \$ 153,537         | \$ 106,434        |

**Note 5. Property and Equipment**

The components of property and equipment are as follows:

|                              | September 30, 2008 | December 31, 2007 |
|------------------------------|--------------------|-------------------|
| Machinery and equipment      | \$ 36,878          | \$ 24,120         |
| Furniture and fixtures       | 24,826             | 19,731            |
| Computers and software       | 18,560             | 11,566            |
| Automobiles and light trucks | 980                | 686               |
| Leasehold improvements       | 64,748             | 40,284            |



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|  |            |           |
|--|------------|-----------|
| Buildings                                      | 2,031      | 1,544     |
| Construction in progress                       | 5,858      | 3,268     |
|  | 153,881    | 101,199   |
| Less accumulated depreciation and amortization | (49,702)   | (36,331)  |
| Total  | \$ 104,179 | \$ 64,868 |

**Table of Contents****Note 6. Long-term Debt**

Long-term debt at September 30, 2008 and December 31, 2007 consists of the following:

|   | September 30, 2008 | December 31, 2007 |
|---|--------------------|-------------------|
| <b>Credit Line Facilities</b>                                     |                    |                   |
| Revolving Credit Facility, maturing December 2008 (a)             | \$ 49,249          | \$ 47,402         |
| Revolving Credit Facility, due on demand (b)                      | 1,060              | 1,170             |
| Total Credit Line Facilities                                      | 50,309             | 48,572            |
| <b>Term Loans and Notes Payable</b>                               |                    |                   |
| Term loan with private investment firm, maturing January 2009 (c) | 51,000             | 51,000            |
| Other   | 703                | 1,000             |
| Total Term Loans and Notes Payable                                | 51,703             | 52,000            |
| Total Long-Term Debt  | 102,012            | 100,572           |
| Less current portion of debt                                      | (101,527)          | (99,930)          |
| Long-Term Debt, net of current portion                            | \$ 485             | \$ 642            |

- (a) At September 30, 2008, the Company's revolving credit facility with LaSalle Bank provided for borrowings up to \$75,000. Borrowings under the facility are subject to certain advance provisions established by the bank and are collateralized by substantially all assets of American Apparel. Interest under the agreement is at LIBOR (3.93% at September 30, 2008) plus 2.5% or the bank's prime rate (5.0% at September 30, 2008) plus 0.5%, at American Apparel's option. The facility expires at the earlier of July 2, 2012 or December 19, 2008, the date thirty days prior to the January 18, 2009 maturity date of the loan agreement with SOF Investments L.P. Private IV, as discussed below, unless it is refinanced on terms acceptable to LaSalle Bank. The average borrowings under the Company's revolving credit facility during the nine months ended September 30, 2008 was \$51,775.

On June 20, 2008, the Registrant, in its capacity as Facility Guarantor, American Apparel (USA), LLC, a subsidiary of the Company, in its capacity as Lead Borrower, and certain other subsidiaries of the Company, in their capacities as Borrowers or Facility Guarantors, entered into a Fourth Amendment to Credit Agreement (the "Fourth Amendment") with LaSalle Business Credit, LLC, LaSalle Bank National Association, Wells Fargo Retail Finance, LLC and the lenders party to the Credit Agreement, dated as of July 2, 2007 (as previously amended, the "LaSalle Credit Agreement"). Capitalized terms used but not defined in this description of the Fourth Amendment have the respective meanings set forth in the LaSalle Credit Agreement.

The Fourth Amendment amended the LaSalle Credit Agreement to, among other things: (i) delete financial covenants relating to minimum Consolidated EBITDA, maximum Capital Expenditures, Consolidated Fixed Charge Coverage Ratio, Senior Debt to Consolidated EBITDA ratio and Adjusted Debt to EBITDAR ratio; (ii) increase Minimum Excess Availability from \$3 million to 10% of the lesser of the Borrowing Base and the Revolving Credit Ceiling; (iii) increase the Permitted Indebtedness threshold for capital leases from \$15,000 to \$20,000; (iv) permit the repurchase of up to \$30,000 of the Loan Parties' capital stock if certain conditions are met; (v) provide additional flexibility for investing in foreign subsidiaries; (vi) add the Registrant as a Facility Guarantor; and (vii) increase from 2.00% to 2.50% the applicable margin for LIBOR-based borrowings and increase from zero to 0.50% the applicable margin for borrowings based on the bank's prime rate.

- (b) As of September 30, 2008, the CI Companies had another line of credit with a bank that provided for borrowings up to C\$4,000 due on demand, bearing interest at the bank's prime rate (4.75% at September 30, 2008) plus 0.75%. This line of credit is secured by a \$7,500 moveable hypothec, which provides for a charge on the CI Companies' accounts receivable, inventory and all other moveable assets and by Section 427 security under the Bank Act of Canada on inventory. The credit agreement contains various covenants which require the CI Companies to maintain certain financial ratios and commitments as defined by the bank.



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(c) As of September 30, 2008, the Registrant had a term loan agreement with SOF Investments L.P. Private IV with a balance of \$51,000. Indebtedness under the agreement bears interest at 16% per annum, payable monthly and matures on January 18, 2009. The agreement requires the Company to meet certain financial covenants. In the event the Company is in default under the agreement, the interest rate increases to 21% per annum and the private investment firm has the right to demand payment in full of all outstanding indebtedness. Any prepayments shall include a prepayment premium equal to 3% of the amount prepaid.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50,000 for the fiscal year ending December 31, 2008. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the Eighth Amendment) with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74,000. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings.

The Company is evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement, which currently matures on January 18, 2009. If by December 19, 2008 the Company is unable to extend or renew the SOF Credit Agreement, or refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, all outstanding obligations under the LaSalle Credit Agreement will become due on December 19, 2008.

**Note 7. Subordinated Notes Payable to Related Party**

The Company has two loans from the Company's CEO, one with a principal balance of \$2,119 and one with a principal balance of \$3,804. At December 31, 2007, the aggregate balance of these loans was \$6,036. At September 30, 2008, the aggregate balance of these loans was \$5,923. Both loans bear interest at 6% per annum commencing December 11, 2007, and mature in 2012. During the three months ended September 30, 2008 and 2007, the aggregate interest expense on both loans was \$90 and \$118, respectively, and \$271 and \$443 during the nine months ended September 30, 2008 and 2007, respectively. Prior to December 12, 2007, these loans were non-interest bearing and without terms of repayment. The Company's CEO subordinated this loan in favor of the Toronto Dominion Bank on February 18, 2008. During the nine months ended September 30, 2008, \$351 was paid to the CEO, of which \$135 was repaid in March 2008, \$205 was repaid in April 2008, and the remaining balance was repaid in May 2008.

**Note 8. Income Taxes**

Income taxes for the three and nine months ended September 30, 2008 were computed using the effective tax rate estimated to be applicable for the full fiscal year, which is subject to ongoing review and evaluation by management.

The Company files income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. In the normal course of business, the Company is subject to examination by relevant tax authorities. The Company is open to audit under the statute of limitations by the Internal Revenue Service for the calendar years ended December 31, 2006 through 2007. The Company's state and foreign tax returns are also open to audit under similar statutes for the years ended December 31, 2004 through 2007, depending on the particular jurisdiction.

The Company's Canadian operations are also currently under audit by the Federal Government of Canada for its calendar year tax returns for 2005 through 2007. The Company does not anticipate that there will be any material changes in its unrecognized tax positions over the next 12 months as a result of these audits.

**Note 9. Related Party Transactions**

In December 2005, the Company entered into an operating lease, which commenced on November 15, 2006, for its knitting facility with a related company, which is partially owned by the CEO and the Chief Manufacturing Officer (CMO) of the Company. The monthly lease payments were approximately \$52 as of September 30, 2008. The lease expires in November 2011, with a five year extension, at the option of the Company. Rent expense was \$155 and \$191 for the three months ended September 30, 2008 and 2007, respectively, and \$464 and \$477 for the nine months ended September 30, 2008 and 2007, respectively. Prior to the Merger, the stockholders of Old American Apparel owned 50% of the company that owns the building which houses the Company's knitting facility. After the Merger, Dov Charney, the Company's CEO, owned 25% of the company that owns the building. Pursuant

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to an Assignment Agreement executed in December 2007, Dov Charney transferred 6.25% of his ownership interest in the company that owns the building to Martin Bailey, the Company's CMO. The value of this assignment of ownership is de minimis.

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In addition, consulting fees charged by an immediate family member of the CEO were \$0 and \$920 for the three months ended September 30, 2008 and 2007, respectively, and were \$0 and \$2,740 for the nine months ended September 30, 2008 and 2007, respectively.

Dov Charney has also provided two unlimited personal guarantees (on behalf of each of the CI Companies) in favor of Toronto Dominion Bank, in connection with the Company's line of credit in Canada. Morris Charney, Dov Charney's father, has also provided two personal guarantees (on behalf of each of the CI Companies), each in the amount of C\$500 in favor of Toronto Dominion Bank, in connection with the line of credit.

**Note 10. Commitments and Contingencies***Operating Leases*

The Company conducts retail operations under operating leases, which expire at various dates through 2020. Future minimum rental payments (excluding real estate tax and maintenance costs) for retail locations and other leases that have initial or non-cancelable lease terms in excess of one year at September 30, 2008 are as follows:

|              |                   |
|--------------|-------------------|
| 2009         | \$ 49,823         |
| 2010         | 45,808            |
| 2011         | 43,595            |
| 2012         | 40,660            |
| 2013         | 38,860            |
| Thereafter   | 126,164           |
| <b>Total</b> | <b>\$ 344,910</b> |

Operating lease rent expense (including real estate taxes and maintenance costs) and leases on a month to month basis were approximately \$18,259 and \$14,218 for the three months ended September 30, 2008 and 2007, respectively, and were approximately \$40,624 and \$29,857 for the nine months ended September 30, 2008 and 2007, respectively. The Company did not incur any contingent rent during the same period. Rent expense is included in Cost of Sales and Operating Expenses in the accompanying Condensed Consolidated Statements of Income.

*Advertising*

At September 30, 2008, the Company had approximately \$4,375 in open advertising commitments, which primarily relate to print advertisements in various newspapers and magazines during the remainder of 2008.

*U.S. Immigration and Customs Enforcement*

The Company has been contacted by U.S. Immigration and Customs Enforcement in regard to performing a review of the Company's compliance with Section 274A of the Immigration and Nationality Act, as amended by the Immigration Reform and Control Act of 1986. The review commenced in January 2008. If the Company is found to have failed to comply with federal law, it could be subject to various civil and criminal penalties. At this time no determination can be made as to the outcome of the review and therefore no provision has been made for a future assessment, if any, which might be imposed by U.S. Immigration and Customs Enforcement upon completion of the review.

*Unused Available Line of Credit*

At September 30, 2008, the Company had a revolving credit facility with LaSalle Bank, providing for borrowings of up to \$75,000 of which \$49,249 was outstanding under this line of credit and \$7,092 was available for future borrowings at September 30, 2008.

At September 30, 2008, the Company had a revolving credit facility with a bank providing for borrowings of up to C\$4,000. C\$1,100 was outstanding under this line of credit and C\$2,900 was available for future borrowings at September 30, 2008. See also Note 6 to the Company's Condensed Consolidated Financial Statements.

*Stock Awards to Employees*

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Pursuant to the Amended Acquisition Agreement, up to 2,710 shares of common stock may be issued to employees subsequent to the filing of the Form S-8 filed in April 2008. On August 14, 2008, 1,851 shares of common stock were awarded to eligible manufacturing employees (Note 3). As of September 30, 2008, the Company estimates there are an additional 859 shares of common stock to be awarded to eligible employees.

**Table of Contents****Note 11. Workers Compensation Self-Insurance Reserves***Self Insurance Reserves*

The Company uses a combination of third-party insurance and/or self-insurance for a number of risks including workers compensation and general liability claims. General liability costs relate primarily to litigation that arises from store operations. Self-insurance reserves include estimates of both claims filed carried at their expected ultimate settlement value and claims incurred but not yet reported. The Company's estimated claim amounts are discounted using a rate with a duration that approximates the duration of the Company's self-insurance reserve portfolio. The Company's liability reflected on the Condensed Consolidated Balance Sheet represents an estimate of the ultimate cost of claims incurred as of the balance sheet date. In estimating this liability, the Company utilizes loss development factors based on Company-specific data to project the future development of incurred losses. Loss estimates are adjusted based upon actual claim settlements and reported claims. These projections are subject to a high degree of variability based upon future inflation rates, litigation trends, legal interpretations, benefit level changes and claim settlement patterns. Although the Company does not expect the amounts ultimately paid to differ significantly from its estimates, self-insurance reserves could be affected if future claim experience differs significantly from the historical trends and the assumptions applied.

The workers compensation liability is based on estimate of losses for claims incurred, but not paid at year end. Funding is made directly to the providers and/or claimants by the insurance company. To guarantee performance under the workers compensation program, as of September 30, 2008 and December 31, 2007, the Company has issued standby letters of credit in the amount of \$7,190 and \$5,940, respectively, with two insurance companies being the beneficiaries, through a bank. At September 30, 2008 and December 31, 2007, the Company recorded a reserve of \$7,094 and \$4,838, respectively, for potential losses on existing claims as such amounts are believed to be probable and reasonably estimable.

**Note 12. Business Segment and Geographic Area Information***Segment Information*

The Company's management evaluates performance based on a number of factors; however, the primary measures of performance are the net sales and income or loss from operations of each segment, as these are the key performance indicators reviewed by management. Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income/expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, information technology, accounting and finance, executive compensation and various other corporate level activity related expenses. Such unallocated expenses remain within corporate. The accounting policies of all operating segments are the same as those described in the summary of significant accounting policies.

The Company reports the following segments: U.S. Wholesale, U.S. Retail, Canada, and International. All of the Company's sales fall into one of these segments. The Company believes this method of segment reporting reflects both the way its business segments are managed and the way each segment's performance is evaluated. The U.S. Wholesale segment includes the Company's wholesale operations in the U.S. and consists of sales of undecorated apparel products to distributors and third party screen printers, and online consumer sales. The U.S. Retail segment includes the Company's retail operations in the U.S. The Canada segment includes the retail and wholesale operations in Canada, as well as online consumer sales. The International segment includes retail, wholesale, and online consumer operations outside of the U.S. and Canada;

As of September 30, 2008, U.S. Retail was comprised of 129 retail stores operating in the United States; the Canada segment was comprised of 34 retail stores operating in Canada; and the International segment was comprised of 65 retail stores operating outside of the U.S. and Canada. All of these retail stores sell the Company's apparel products directly to consumers.

During the three and nine months ended September 30, 2008, 1,851 shares of the Company's common stock having an aggregate value of \$12,102 were awarded to eligible manufacturing employees. The stock awarded resulted in the recording of \$12,102 of share based compensation expense and \$1,095 of employer related payroll taxes as part of cost of sales and decreased gross profit in the U.S. Wholesale segment by \$13,197 during the three and nine months ended September 30, 2008. The U.S. Retail, Canada and International segments purchase substantially all of their finished goods apparel from the U.S. Wholesale segment. Inter-segment sales are recorded at standard costs. Variances between standard costs and actual costs are reflected entirely in the U.S. Wholesale segment.

During the nine months ended September 30, 2008, the Company made certain reclassifications within its Canada segment reporting presentation for 2007 to conform to the current period presentation. The Company reclassified foreign currency transaction (gain) loss in the amount of \$(29) and \$472 for the three and nine months ended September 30, 2007 from cost of sales to foreign currency transaction (gain). The reclassification resulted in a \$29 decrease to gross profit and income from operations and an increase to foreign currency transaction (gain) loss



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for the three months ended September 30, 2007. The reclassification resulted in a \$472 increase to gross profit, income from operations and foreign currency transaction loss for the nine months ended September 30, 2007.

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The following table presents key financial information for the Company's business segments:

|   | Three Months Ended September 30, 2008 |             |           |               |              |
|---|---------------------------------------|-------------|-----------|---------------|--------------|
|   | U.S.<br>Wholesale                     | U.S. Retail | Canada    | International | Consolidated |
| Net sales to external customers                   | \$ 46,219                             | \$ 46,675   | \$ 19,874 | \$ 42,033     | \$ 154,801   |
| Gross profit (loss)                               | (3,381)                               | 35,561      | 13,882    | 31,560        | 77,622       |
| Income (loss) from operations                     | (11,172)                              | 10,640      | 6,383     | 10,409        | 16,260       |
| Inter-segment sales (eliminated in consolidation) | 41,697                                |             |           |               |              |
| Depreciation and amortization                     | 1,912                                 | 1,810       | 355       | 1,346         | 5,423        |
| Capital expenditures                              | 3,502                                 | 10,225      | 1,339     | 5,938         | 21,004       |
| Deferred rent expense                             | 168                                   | 1,032       | 107       | 173           | 1,480        |

|   | Three Months Ended September 30, 2007 |             |           |               |              |
|---|---------------------------------------|-------------|-----------|---------------|--------------|
|   | U.S.<br>Wholesale                     | U.S. Retail | Canada    | International | Consolidated |
| Net sales to external customers                   | \$ 40,092                             | \$ 31,432   | \$ 12,195 | \$ 22,901     | \$ 106,620   |
| Gross profit                                      | 11,438                                | 23,967      | 7,307     | 16,148        | 58,860       |
| Income from operations                            | 5,568                                 | 7,237       | 1,262     | 4,143         | 18,210       |
| Inter-segment sales (eliminated in consolidation) | 20,017                                |             |           |               |              |
| Depreciation and amortization                     | 1,271                                 | 1,132       | 454       | 365           | 3,222        |
| Capital expenditures                              | 1,204                                 | 3,010       | 571       | 1,226         | 6,011        |
| Deferred rent (benefit) expense                   | (38)                                  | 235         | 41        | (13)          | 225          |

|   | Nine Months Ended September 30, 2008 |             |           |               |              |
|---|--------------------------------------|-------------|-----------|---------------|--------------|
|   | U.S.<br>Wholesale                    | U.S. Retail | Canada    | International | Consolidated |
| Net sales to external customers                   | \$ 124,665                           | \$ 118,838  | \$ 48,549 | \$ 107,354    | \$ 399,406   |
| Gross profit                                      | 15,989                               | 90,043      | 33,861    | 78,548        | 218,441      |
| (Loss) income from operations                     | (4,953)                              | 24,330      | 12,300    | 23,654        | 55,331       |
| Inter-segment sales (eliminated in consolidation) | 101,071                              |             |           |               |              |
| Depreciation and amortization                     | 5,090                                | 4,688       | 1,409     | 3,127         | 14,314       |
| Capital expenditures                              | 12,935                               | 21,406      | 3,188     | 14,545        | 52,074       |
| Deferred rent expense                             | 62                                   | 2,692       | 319       | 2,512         | 5,585        |

|   | Nine Months Ended September 30, 2007 |             |           |               |              |
|---|--------------------------------------|-------------|-----------|---------------|--------------|
|   | U.S.<br>Wholesale                    | U.S. Retail | Canada    | International | Consolidated |
| Net sales to external customers                   | \$ 106,466                           | \$ 80,411   | \$ 30,234 | \$ 58,742     | \$ 275,853   |
| Gross profit                                      | 32,256                               | 62,363      | 19,688    | 41,111        | 155,418      |
| Income from operations                            | 18,049                               | 16,397      | 3,026     | 11,408        | 48,880       |
| Inter-segment sales (eliminated in consolidation) | 52,881                               |             |           |               |              |
| Depreciation and amortization                     | 3,655                                | 3,192       | 1,245     | 1,210         | 9,302        |
| Capital expenditures                              | 2,350                                | 5,154       | 819       | 3,386         | 11,709       |
| Deferred rent (benefit) expense                   | (112)                                | 993         | 97        | 78            | 1,056        |

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|  | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                   |
|--|----------------------------------|-------------------|---------------------------------|-------------------|
|  | 2008                             | 2007              | 2008                            | 2007              |
| <b>Reconciliation to Income before Income Taxes</b>        |                                  |                   |                                 |                   |
| Consolidated income from operations of reportable segments | \$ 16,260                        | \$ 18,210         | \$ 55,331                       | \$ 48,880         |
| Corporate expenses   | (9,418)                          | (6,498)           | (28,496)                        | (18,394)          |
| Interest expense   | (3,237)                          | (4,397)           | (10,274)                        | (13,149)          |
| Other income (expense)                                     | 636                              | 539               | (133)                           | 1,081             |
| Foreign currency transaction gain (loss)                   | (1,049)                          | 271               | (1,047)                         | (453)             |
| <b>Consolidated Income Before Income Taxes</b>             | <b>\$ 3,192</b>                  | <b>\$ 8,125</b>   | <b>\$ 15,381</b>                | <b>\$ 17,965</b>  |
| <b>Net sales by location of customer</b>                   |                                  |                   |                                 |                   |
| United States  | \$ 92,894                        | \$ 73,059         | \$ 243,503                      | \$ 186,876        |
| Canada   | 19,874                           | 12,195            | 48,549                          | 30,234            |
| Germany  | 21,289                           | 12,056            | 55,520                          | 31,567            |
| United Kingdom   | 9,943                            | 3,242             | 24,972                          | 11,224            |
| Korea  | 3,452                            | 2,894             | 8,998                           | 7,163             |
| Japan  | 3,806                            | 2,676             | 10,847                          | 7,147             |
| Other foreign countries                                    | 3,543                            | 498               | 7,017                           | 1,642             |
| <b>Total Consolidated Net Sales</b>                        | <b>\$ 154,801</b>                | <b>\$ 106,620</b> | <b>\$ 399,406</b>               | <b>\$ 275,853</b> |

Long-lived assets Property and equipment, net, is summarized as follows:

|                                       | September 30, 2008 | December 31, 2007 |
|---------------------------------------|--------------------|-------------------|
| United States                         | \$ 71,447          | \$ 43,984         |
| Canada                                | 7,931              | 6,623             |
| Germany                               | 11,417             | 7,273             |
| United Kingdom                        | 6,883              | 4,594             |
| Korea                                 | 663                | 512               |
| Japan                                 | 2,934              | 1,636             |
| Other foreign countries               | 2,904              | 246               |
| <b>Consolidated Long-lived Assets</b> | <b>\$ 104,179</b>  | <b>\$ 64,868</b>  |
| <b>Identifiable assets by segment</b> |                    |                   |
| U.S. Wholesale                        | \$ 167,542         | \$ 125,422        |
| U.S. Retail                           | 86,101             | 59,961            |
| Canada                                | 23,499             | 16,506            |
| International                         | 51,897             | 31,461            |
| <b>Total Assets</b>                   | <b>\$ 329,039</b>  | <b>\$ 233,350</b> |

Foreign subsidiaries accounted for the following percentages of assets and total liabilities:

|                   | September 30, 2008 | December 31, 2007 |
|-------------------|--------------------|-------------------|
| Total assets      | 22.9%              | 20.6%             |
| Total liabilities | 17.8%              | 17.4%             |

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|  | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                   |
|--|----------------------------------|-------------------|---------------------------------|-------------------|
|  | 2008                             | 2007              | 2008                            | 2007              |
| <b>Net sales by class of customer:</b> |                                  |                   |                                 |                   |
| <b>U.S. Wholesale</b>                  |                                  |                   |                                 |                   |
| Wholesale                              | \$ 39,064                        | \$ 35,677         | \$ 106,806                      | \$ 95,422         |
| Online consumer                        | 7,155                            | 4,415             | 17,859                          | 11,044            |
| <b>Total</b>                           | <b>\$ 46,219</b>                 | <b>\$ 40,092</b>  | <b>\$ 124,665</b>               | <b>\$ 106,466</b> |
| <b>U.S. Retail</b>                     |                                  |                   |                                 |                   |
|  | \$ 46,675                        | \$ 31,432         | \$ 118,838                      | \$ 80,411         |
| <b>Canada</b>                          |                                  |                   |                                 |                   |
| Wholesale                              | \$ 3,574                         | \$ 3,193          | \$ 9,751                        | \$ 8,720          |
| Retail                                 | 15,818                           | 8,729             | 37,531                          | 20,927            |
| Online consumer                        | 482                              | 273               | 1,267                           | 587               |
| <b>Total</b>                           | <b>\$ 19,874</b>                 | <b>\$ 12,195</b>  | <b>\$ 48,549</b>                | <b>\$ 30,234</b>  |
| <b>International</b>                   |                                  |                   |                                 |                   |
| Wholesale                              | \$ 3,778                         | \$ 2,446          | \$ 11,566                       | \$ 9,193          |
| Retail                                 | 34,935                           | 18,774            | 86,920                          | 45,460            |
| Online consumer                        | 3,320                            | 1,681             | 8,868                           | 4,089             |
| <b>Total</b>                           | <b>\$ 42,033</b>                 | <b>\$ 22,901</b>  | <b>\$ 107,354</b>               | <b>\$ 58,742</b>  |
| <b>Consolidated</b>                    |                                  |                   |                                 |                   |
| Wholesale                              | \$ 46,416                        | \$ 41,316         | \$ 128,123                      | \$ 113,335        |
| Retail                                 | 97,428                           | 58,935            | 243,289                         | 146,798           |
| Online consumer                        | 10,957                           | 6,369             | 27,994                          | 15,720            |
| <b>Total Consolidated Net Sales</b>    | <b>\$ 154,801</b>                | <b>\$ 106,620</b> | <b>\$ 399,406</b>               | <b>\$ 275,853</b> |

**Note 13. Litigation**

The Company is subject to various claims and contingencies in the ordinary course of its business, including those related to litigation, business transactions, employee-related matters and taxes, and others. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the Company will record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. Most of these matters are covered by insurance which the Company expects will be sufficient to cover all litigation costs, potential settlements or any adverse judgments, except for any applicable deductible or retention amounts. Accordingly, the Company does not expect that any of its pending legal proceedings will have any material financial impact on the Company's results.

On March 31, 2008, Woody Allen filed suit against the Company, in the United States District Court for the Southern District of New York, for the alleged unauthorized use of his image. Through his suit, Mr. Allen is seeking monetary damages in an amount he believes to be in excess of \$10 million, disgorgement of any profits the Company may have realized as a result of its alleged unauthorized use of Mr. Allen's image, exemplary damages, and attorneys' fees and costs. The Company believes that Mr. Allen's claims are defensible and is vigorously litigating its position. In addition, the Company's insurance company has agreed, without any reservation of rights, to cover all defense costs and any adverse judgment which may be entered against the Company, up to the policy limits of \$11 million, except for any exemplary damages which may be awarded. While there can be no assurances, the Company does not expect that there will be a material financial impact as a result of this suit.

On or about September 19, 2005, Ms. Mary Nelson, an independent contractor in the sales department at American Apparel commenced a suit in a case captioned as Mary Nelson v. American Apparel, Inc., et al., wherein she alleges she was wrongfully terminated, was subjected to

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harassment and discrimination based upon her gender and other claims related to her tenure at American Apparel. The Company denies all of Ms. Nelson's allegations of wrongdoing. Ms. Nelson is seeking unspecified monetary damages and costs. The trial has been stayed, and the Court of Appeal of the State of California has reversed the Superior Court's denial of the Company's motion to compel arbitration pursuant to an agreement among the parties. The Company anticipates that an arbitration will now occur. As described further in the Company's Form 10-K for the

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year ended December 31, 2007, the insurance carrier for the Company's directors and officers' insurance policy has asserted that it is not obligated to provide coverage for this proceeding.

Other than as stated above, during the three months ended September 30, 2008, there have been no material changes in the Company's legal proceedings previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2007 for information regarding current legal proceedings.

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

American Apparel, Inc., a Delaware corporation, was incorporated in Delaware on July 22, 2005 as Endeavor Acquisition Corp., (the Registrant) a blank check company formed to acquire an operating business. On December 21, 2005, the Registrant consummated its initial public offering, and on December 18, 2006, entered into an Agreement and Plan of Reorganization with American Apparel and its affiliated companies. On November 6, 2007, the Registrant entered into an amended Acquisition Agreement with Old American Apparel and its affiliated companies. The Registrant consummated the acquisition of American Apparel and its affiliated companies on December 12, 2007 (the Merger) and changed its name to American Apparel, Inc.

The Merger was accounted for under the purchase method of accounting as a reverse acquisition. Accordingly, for accounting and financial reporting purposes, Endeavor Acquisition Corp. was treated as the acquired company, and Old American Apparel was treated as the acquiring company. The historical financial information for periods and dates prior to December 12, 2007, is that of Old American Apparel and its affiliated companies.

**Overview**

The Company designs, manufactures and sells fashion apparel for women, men, children and pets. The Company sells its products through its retail stores and through its wholesale operations, which include web-based operations, throughout the U.S. and internationally. American Apparel's revenue is driven by its ability to design and market desirable products by identifying new business opportunities, securing new distribution channels, and renewing and revitalizing existing distribution channels.

**Nature of Operations**

The Company is a vertically integrated manufacturer, distributor, and retailer of fashion basic apparel. As of September 30, 2008, American Apparel operated 228 retail stores in 19 countries. The Company also operates a wholesale business that supplies T-shirts and other casual wear to distributors and screen printers.

The Company conducts its primary manufacturing operations out of an 800,000 square foot facility in downtown Los Angeles. The facility houses its executive offices, as well as the Company's cutting, sewing, warehousing, and distribution operations. In addition, the Company operates a knitting facility in Los Angeles where it makes about one third of the fabric the Company uses in manufacturing. A Company owned dye house dyes one third of the raw fabric that the Company uses in its manufacturing operations. To supplement the Company's in-house production capacity in December 2007, the Company acquired a new garment dye facility, which began operations in January 2008.

On May 9, 2008, the Company completed an asset purchase with an unrelated third party to assume a lease and purchase all of the assets of a fabric dyeing and finishing plant.

On July 2, 2008, to supplement the Company's warehouse operations, the Company entered into a lease on a warehouse in Los Angeles, California with approximately 300,000 square feet of space. The lease has an initial term of 10 years and 5 months, with an initial annual rent of \$0.8 million.

In addition, on July 29, 2008, the Company entered into an agreement to purchase the leasehold interests of seven retail locations for cash consideration of \$0.6 million. The seven stores were opened during the three months ended September 30, 2008.

On August 14, 2008, approximately 1.9 million shares of the Company's common stock having an aggregate value of \$12.1 million were awarded to eligible manufacturing employees and included in cost of sales in the accompanying condensed consolidated statements of income for the three and nine months ended September 30, 2008. Of the \$12.1 million, \$5.2 million was withheld for the payment of employment and withholding taxes and approximately 1.1 million shares with an aggregate value of \$6.9 million were issued to employees and cash was paid to employees in lieu of the issuance of fractional shares. The value of the stock award was determined based on the closing price of common stock of \$6.54 on August 14, 2008 (date of grant).

On September 29, 2008, to supplement the Company's operations, the Company entered into a lease on a facility in Commerce, California with approximately 235,000 square feet of space. The lease has an initial term of 5 years and 3 months, with an initial annual rent of \$0.5 million.

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Because the Company's manufacturing process is vertically integrated and based in the United States, the Company is able to quickly respond to customer demand, react quickly to changing fashion trends, and closely monitor quality. The Company's garments are noted for their quality and fit, and the Company's distinctive branding has differentiated it in the marketplace.

The business reporting segments of the Company are U.S. Retail, U.S. Wholesale, Canada, and International. The Company believes this method of segment reporting reflects both the way its business segments are managed and the way each segment's



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performance is evaluated. The U.S. Retail segment includes the Company's retail operations in the U.S. The U.S. Wholesale segment includes the Company's wholesale operations in the U.S. and its online operations in the U.S. The Canada business segment includes retail, wholesale, and online operations in Canada. The International segment includes retail, wholesale, and online operations outside of the U.S. and Canada. The business segments' results exclude corporate expenses, which consist of the shared costs of the organization. These costs are presented separately and generally include, among other things, the following corporate costs: information technology, human resources, accounting and finance, executive compensation and legal. Financial information about each segment, together with certain geographical information, for the three and nine months ended September 30, 2008 and 2007 are included in the Condensed Consolidated Financial Statements contained herein.

As of September 30, 2008, the U.S. Retail segment consisted of 129 retail stores in the United States and the U.S. Wholesale segment consisted of wholesale operations and online operations in the U.S. As of September 30, 2008, the Canada segment consisted of 34 retail stores along with wholesale and online operations in Canada while the International segment consisted of 65 retail stores in 17 countries, 9 online storefronts, and 7 overseas wholesale operations. The International segment consisted of the Company's business in the United Kingdom, Germany, France, Italy, the Netherlands, Sweden, Switzerland, Israel, Mexico, Australia, Japan, South Korea, China, Belgium, Spain, Austria and Brazil.

For the three months ended September 30, 2008, 29.9% of the Company's net revenue was generated from U.S. Wholesale operations, 30.2% from U.S. Retail operations, 12.8% from Canada operations and 27.1% from International operations. For the three months ended September 30, 2007, 37.6% of American Apparel's net sales were generated from U.S. Wholesale operations, 29.5% from U.S. Retail operations, 11.4% from Canada operations and 21.5% from International operations. For the nine months ended September 30, 2008, 31.2% of the Company's net sales were generated from U.S. Wholesale operations, 29.8% from U.S. Retail operations, 12.2% from Canada operations and 26.8% from International operations. For the nine months ended September 30, 2007, 38.6% of the Company's net sales were generated from U.S. Wholesale operations, 29.1% from U.S. Retail operations, 11.0% from Canada operations and 21.3% from International operations.

During the period from October 1, 2007 through September 30, 2008, the Company increased its U.S.-based retail stores from 96 to 129 and increased its Canada based stores from 25 to 34, while establishing an additional 24 retail outlets and closing 1 store internationally. The following table details the growth in retail store activity during the three and nine months ended September 30, 2008 and 2007.

|  | United States | Canada | International | Total |
|--|---------------|--------|---------------|-------|
| <b>Three Months Ended September 30, 2007</b> |               |        |               |       |
| Open at July 1, 2007                         | 95            | 25     | 34            | 154   |
| Opened                                       | 2             | 0      | 8             | 10    |
| Closed                                       | (1)           | 0      | 0             | (1)   |
| Total as of September 30, 2007               | 96            | 25     | 42            | 163   |
| <b>Three Months Ended September 30, 2008</b> |               |        |               |       |
| Open at July 1, 2008                         | 109           | 30     | 56            | 195   |
| Opened                                       | 20            | 4      | 9             | 33    |
| Closed                                       | 0             | 0      | 0             | 0     |
| Total as of September 30, 2008               | 129           | 34     | 65            | 228   |
| <b>Nine Months Ended September 30, 2007</b>  |               |        |               |       |
| Open at January 1, 2007                      | 93            | 26     | 28            | 147   |
| Opened                                       | 4             | 0      | 14            | 18    |
| Closed                                       | (1)           | (1)    | 0             | (2)   |
| Total as of September 30, 2007               | 96            | 25     | 42            | 163   |
| <b>Nine Months Ended September 30, 2008</b>  |               |        |               |       |
| Open at January 1, 2008                      | 105           | 30     | 47            | 182   |
| Opened                                       | 24            | 5      | 19            | 48    |
| Closed                                       | 0             | (1)    | (1)           | (2)   |

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|                                |     |    |    |     |
|--------------------------------|-----|----|----|-----|
| Total as of September 30, 2008 | 129 | 34 | 65 | 228 |
|--------------------------------|-----|----|----|-----|

**Table of Contents****Comparable Store Sales**

Comparable store sales are defined as the change in sales for stores that have been open for more than 12 months. The table below shows the percentage increase in comparable store sales of the Company, for the three and nine months ended September 30, 2008, compared to the three and nine months ended September 30, 2007 and for the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, including the number of stores included in the comparison at the end of each period.

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Comparable store sales increase from prior year period | 24%                | 27%                | 27%                | 24%                |
| Number of stores in comparison at end of period        | 149                | 129                | 149                | 129                |

**Executive Summary**

For the three months ended September 30, 2008, the Company reported net sales of \$154.8 million, an increase of \$48.2 million, or 45.2%, over the \$106.6 million reported for the three months ended September 30, 2007. The increase in net sales was primarily the result of expansion in the U.S. Wholesale and U.S. Retail distribution channels, the Canada retail distribution channel and the International retail distribution channel, as the Company added new store locations and expanded its product offerings in existing stores. The Company selects new store locations based upon consideration of a number of factors, including projected sales potential, financial requirements of the prospective lease agreement, co-tenancy, as well as ancillary benefits such as increase in brand recognition. During 2007, the Company expanded its fabric offerings which facilitated introduction of new styles across the wholesale and retail distribution channels. As many as thirty new styles were added to the retail distribution channel of which the most notable was the addition of denim products. Comparable store sales increased 24% for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007.

Gross profit percentage for the Company decreased to 50.1% in the three months ended September 30, 2008 compared to 55.2% for the three months ended September 30, 2007. The decrease in gross profit was primarily the result of recording \$12.1 million of share based compensation expense related to the stock award of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008 and \$1.1 million of employer related payroll taxes in cost of sales for the three months ended September 30, 2008. The \$13.2 million of expenses related to the stock award reduced our gross profit percentage by 8.5%. Excluding the impact of the aforementioned expenses related to the stock award, our gross profit percentage increased to 58.6% in the three months ended September 30, 2008 from 55.2% for the three months ended September 30, 2007. The increase in gross profit percentage was primarily attributed to an increase in the sales mix during 2008 which included a higher amount of retail sales from the expansion of the U.S. Retail, Canada and International segments which generate a higher margin than the Company's U.S. Wholesale segment. The gross profit margin was also favorably impacted from a reduction in inventory reserves of \$1.1 million which increased the gross profit margin by 0.7% during the three months ended September 30, 2008. The reduction in the inventory reserve was primarily the result of the opening of two closeout stores in key markets and expansion of certain existing closeout stores to increase inventory for sale. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores, resulting in higher inventory turnover of potentially obsolete inventory.

During the three months ended September 30, 2008, the Company continued to hire a significant number of new manufacturing employees to support the increased production activity to support the growth in the Company's operations. Related to this activity, the Company incurred additional recruiting and training costs. Typically, gross margin in the U.S. Wholesale distribution channel is negatively impacted during periods in which the Company undergoes an increased level of hiring.

As of April 1, 2008, the Company successfully completed the first phase of the implementation of an Enterprise Resources Planning (ERP) system. This first phase included the conversion of the Company's systems for manufacturing and warehouse operations, inventory management and control and wholesale operations. Direct costs incurred in the implementation during the three and nine months ended September 30, 2008 were \$0.4 million and \$1.6 million, respectively. In addition, certain indirect costs and inefficiencies related to the changeover of various system components had a minor negative impact upon the results of operations in 2008. Nonetheless, going forward the improvements in operating information and control systems are expected to be substantial. Since April 1, 2008, the Company has entered the second phase of the implementation, which will include the financial accounting and control systems for the Company's U.S. operations. Completion of the second phase is scheduled to be completed in 2009.

The Company's net income for the three months ended September 30, 2008 decreased to \$2.3 million compared to \$6.0 million for the three months ended September 30, 2007. The decrease in net income during the three months ended September 30, 2008 was primarily the result of the aforementioned expense attributed to the stock award to the Company's manufacturing employees on August 14, 2008.



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In the three months ended September 30, 2008, 30.2% of the Company's net revenue was generated from U.S. Retail operations, 29.9% from U.S. Wholesale operations, 12.8% from Canada operations and 27.1% from International operations. Total net revenue for the three months ended September 30, 2008 was \$154.8 million and total net income for the same period was \$2.3 million.

In the nine months ended September 30, 2008, 29.8% of the Company's net revenue was generated from U.S. Retail operations, 31.2% from U.S. Wholesale operations, 12.2% from Canada operations and 26.8% from International operations. Total net revenue for the nine months ended September 30, 2008 was \$399.4 million and total net income for the same period was \$10.2 million.

The Company's net income for the nine months ended September 30, 2008 decreased to \$10.2 million compared to \$12.5 million for the nine months ended September 30, 2007. The decrease in net income during the nine months ended September 30, 2008 was primarily the result of the aforementioned expense attributed to the stock award to the Company's manufacturing employees on August 14, 2008 offset by an increase in income from operations as a result of the continued expansion of the Company's operations in the U.S. Retail, Canada and International segments.

Management of the Company believes that its revenue growth has been enhanced by the addition of new stores, increased online sales, and by an increased focus on building brand awareness and product diversity. This increased focus is designed to keep existing retail customers and to attract new retail customers. To build on this trend in retail revenue growth, the Company is looking to grow its U.S. Retail segment, and the retail portion of its International and Canada segments. As of September 30, 2008, the Company had signed leases for an additional 40 store locations. Additionally, the Company is currently selecting, negotiating and reviewing additional new store locations in both domestic and foreign markets.

As the Company's business grows, management is evaluating its existing systems. It is expected that the new ERP system will enable the Company to purchase more efficiently, as well as manage the supply chain and inventory more efficiently. The Company, while currently able to meet its production requirements using both internal and third party resources, is developing strategies to increase its internal production capacity to meet future needs.

## **Seasonality**

The Company experiences seasonality in its operations. Historically, sales during the second and third fiscal quarters have generally been the highest, with sales during the first fiscal quarter the lowest. This reflects the combined impact of the seasonality of the wholesale and retail segments. Generally, the Company's retail segment has not experienced the same pronounced sales seasonality as other retailers.

## **Critical Accounting Estimates and Policies**

Complete descriptions of the Company's significant accounting policies are outlined in the *Notes to Consolidated Financial Statements* included in this Form 10-Q and the Annual Report on Form 10-K for the year ended December 31, 2007. The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The Company's most critical accounting estimates and policies include:

revenue recognition;

sales returns and allowances for doubtful accounts;

inventory valuation and obsolescence;

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valuation and recoverability of long-lived intangible assets including the values assigned to acquired intangible assets, goodwill, and property and equipment;

income taxes;

foreign currency; and

accruals for the outcome of current litigation.

In general, estimates are based on historical experience, on information from third party professionals and on various other sources and assumptions that are believed to be reasonable under the facts and circumstances at the time such estimates are made. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted

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accordingly. Actual results may vary from these estimates and assumptions under different and/or future circumstances. The Company's management considers an accounting estimate to be critical if:

it requires assumptions to be made that were uncertain at the time the estimate was made; and

changes in the estimate, or the use of different estimating methods that could have been selected, could have a material impact on the Company's consolidated results of operations or financial condition.

### **Revenue Recognition**

The Company recognizes product sales revenue when title and risk of loss have transferred to the customer, there is persuasive evidence of an arrangement, shipment and passage of title has occurred, the sales price is fixed or determinable and collectability is reasonably assured. Revenue from wholesale product sales is recorded at the time the product is shipped to the customer. Revenue from online sales is recorded at the time the products are delivered to the customers. With respect to its retail store operations, the Company recognizes revenue upon the sale of its products to retail customers. The Company's net sales represent gross sales invoiced to customers, less certain related charges for discounts, returns, and other promotional allowances and are recorded net of sales or value added tax. Allowances provided for these items are presented in the consolidated financial statements primarily as reductions to sales and cost of sales (see "Sales Returns and Allowances" discussed below for further information).

The Company recognizes the sales from gift cards, gift certificates and store credits as they are redeemed for merchandise. Prior to redemption, the Company maintains an unearned revenue liability for gift cards, gift certificates and store credits until the Company is released from such liability. The Company's gift cards, gift certificates and store credits do not have expiration dates.

### **Sales Returns and Allowances**

The Company analyzes sales returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48 "Revenue Recognition When Right of Return Exists" (SFAS 48). The Company is able to make reasonable and reliable estimates of product returns for its wholesale, online product sales and retail store sales based upon historical experience. The Company also monitors the buying patterns of the end-users of its products based on sales data received by its retail outlets. Estimates for sales returns are based on a variety of factors including actual returns based on expected return data communicated to it by customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. As with any set of assumptions and estimates, there is a range of reasonably likely amounts that may be calculated for the Company's allowance for sales returns above. However, the Company believes that there would be no significant difference in the amounts reported using other reasonable assumptions than what was used to arrive at the allowance. The Company regularly reviews the factors that influence its estimates and, if necessary, makes adjustments when it believes that actual product returns and credits may differ from established reserves. Actual experience may be significantly different than the Company's estimates due to various factors, including, but not limited to, changes in sales volume based on consumer demand and competitive conditions. If actual or expected future returns and claims are significantly greater or lower than the allowance for sales returns that the Company had established, the Company would record a reduction or increase to net revenues in the period in which it made such determination.

### **Trade Receivables**

Accounts receivable primarily consists of trade receivables, including amounts due from credit card companies, net of allowances. On a periodic basis, the Company evaluates its trade receivables and establishes an allowance for doubtful accounts based on a history of past bad debt expense, collections and current credit conditions.

The Company performs on-going credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by the review of their current credit information. Collections and payments from customers are continuously monitored. The Company maintains an allowance for doubtful accounts, which is based upon historical experience as well as specific customer collection issues that have been identified. While such bad debt expenses have historically been within expectations and allowances established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past. If the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

### **Inventories**

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Inventories are stated at the lower of cost or market. Cost is primarily determined on the first-in, first-out ( FIFO ) method. The Company identifies potentially excess and slow-moving inventories by evaluating turn rates, inventory levels and other factors. Excess quantities are identified through evaluation of inventory aging, review of inventory turns and historical sales experiences. At times however, the Company will purposefully engage in inventory build up at a rate that outpaces sales. This is typically done during the first and second quarters in anticipation of the peak selling season which occurs during the summer months of the second and third quarters of the year. At such times, the Company will consider the timing of inventory buildup in order to determine whether the buildup warrants additional reserves for inventory obsolescence. If the inventory buildup precedes the selling season,



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management maintains the existing provision for inventory obsolescence until the peak selling season has passed and the accumulated sales data provides a better basis for an update of management's estimate of this provision. The Company has evaluated the current level of inventories considering historical sales and other factors and, based on this evaluation, has recorded adjustments to cost of goods sold to adjust inventories to net realizable value. These adjustments are estimates, which could vary significantly, either favorably or unfavorably, from actual requirements if future economic conditions, customer demand or competition differ from expectations. Other significant estimates include the allocation of variable and fixed production overheads. While variable production overheads are allocated to each unit of production on the basis of actual use of production facilities, the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the Company's production facilities. Certain costs, including categories of indirect materials, indirect labor and other indirect manufacturing costs which are included in the overhead pool are estimated. The Company determines its normal capacity based upon the amount of direct labor minutes in a reporting period.

During the third quarter of 2008, the Company opened two closeout stores in key markets and expanded certain existing closeout stores to increase their available inventory for sale. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores, resulting in higher inventory turnover of potentially obsolete inventory. The impact of this sales increase in our closeout stores was the primary result of a net reduction of \$1.1 million to the Company's reserve for inventory obsolescence at September 30, 2008.

### **Goodwill and Other Intangible Assets**

Goodwill and other intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The SFAS 142 goodwill impairment model is a two-step process. The first step compares the fair value of a reporting unit that has goodwill assigned to its carrying value. The Company estimates the fair value of a reporting unit by using a discounted cash flow model. If the fair value of the reporting unit is determined to be less than its carrying value, a second step is performed to compute the amount of goodwill impairment, if any. Step two allocates the fair value of the reporting unit to the reporting unit's net assets other than goodwill. The excess of the fair value of the reporting unit over the amounts assigned to its net assets other than goodwill is considered the implied fair value of the reporting unit's goodwill. The implied fair value of the reporting unit's goodwill is then compared to the carrying value of its goodwill. Any shortfall represents the amount of goodwill impairment.

### **Long-Lived Assets**

The Company periodically reviews the values assigned to long-lived assets, such as property and equipment, intangibles and goodwill. The associated depreciation and amortization periods are reviewed on an annual basis.

### **Impairment of Long-Lived Assets**

The Company follows the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). SFAS 144 requires evaluation of the need for an impairment charge relating to long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write down to a new depreciable basis is required. If required, an impairment charge is recorded based on an estimate of future discounted cash flows.

The Company considers the following to be some examples of important indicators that may trigger an impairment review: (i) significant under-performance or losses of retail stores relative to expected historical or projected future operating results; (ii) significant changes in the manner or use of the assets or in American Apparel's overall strategy with respect to the manner or use of the acquired assets or changes in American Apparel's overall business strategy; (iii) significant negative industry or economic trends; (iv) increased competitive pressures; (v) a significant decline in American Apparel's stock price for a sustained period of time; and (vi) regulatory changes.

The Company evaluates acquired assets and its retail stores for potential impairment indicators at least annually and more frequently upon the occurrence of certain events. Judgment regarding the existence of impairment indicators is based on market conditions and operational performance of the acquired businesses. Future events could cause the Company to conclude that impairment indicators exist, and therefore that goodwill and other intangible assets as well as other long lived assets are impaired. Such evaluations for impairment are significantly impacted by estimates of future revenues, costs and expenses and other factors. A significant change in cash flows in the future could result in an impairment of long lived assets. During the nine months ended September 30, 2008, the Company recorded an impairment charge in the amount of \$0.2 million related to three underperforming retail stores of which one is located in each of the U.S. Retail, Canada and International segments.



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### **Foreign Currency**

In preparing the consolidated financial statements, the financial statements of the foreign subsidiaries are translated from the functional currency, generally the local currency, into U.S. Dollars. This process results in exchange rate gains and losses, which, under the relevant accounting guidance, are included as a separate component of stockholders' equity under the caption "Accumulated other comprehensive income."

Under the relevant accounting guidance, the functional currency of each foreign subsidiary is determined based on management's judgment and involves consideration of all relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary transacts a majority of its transactions, including billings, financing, payroll and other expenditures, would be considered the functional currency, but any dependency upon the parent and the nature of the subsidiary's operations must also be considered.

If a subsidiary's functional currency is deemed to be the local currency, then any gain or loss associated with the translation of that subsidiary's financial statements is included in accumulated other comprehensive income. However, if the functional currency is deemed to be the U.S. Dollar, then any gain or loss associated with the re-measurement of these financial statements from the local currency to the functional currency would be included within the statement of operations. If the Company disposes of subsidiaries, then any cumulative translation gains or losses would be recorded into the statement of operations. If the Company determines that there has been a change in the functional currency of a subsidiary to the U.S. Dollar, any translation gains or losses arising after the date of change would be included within the statement of operations.

Based on an assessment of the factors discussed above, the Company considers the relevant subsidiary's local currency to be the functional currency for each of its foreign subsidiaries.

### **Income Taxes**

The Company records the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and amounts reported in the accompanying consolidated balance sheets, as well as tax credit carrybacks and carryforwards. The Company periodically reviews the recoverability of deferred tax assets recorded on the balance sheet and provides valuation allowances as management deems necessary. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

### **Contingencies**

The Company is subject to proceedings, lawsuits and other claims related to various matters. The Company assesses the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. Management determines the amount of reserves needed, if any, for each individual issue based on its knowledge and experience and discussions with legal counsel. The required reserves may change in the future due to new developments in each matter, the ultimate resolution of each matter or changes in approach, such as a change in settlement strategy, in dealing with these matters. The Company currently does not believe, based upon information available at this time, that these matters will have a material adverse effect on its consolidated financial position, results of operations or cash flows. However, there is no assurance that such matters will not materially and adversely affect the Company's business, financial position, results of operations or cash flows. See Note 13 to the Company's Condensed Consolidated Financial Statements.

### **Equity**

The Company intends to use stock options and other stock-based awards to reward long-term performance. The Company believes that providing a meaningful portion of an executive's total compensation package in stock options and other stock-based awards will align the incentives of its executives with the interests of stockholders and with the Company's long-term success. The Company expects the compensation committee and Board to develop their equity award determinations based on their judgments as to whether the complete compensation packages provided to executives, sufficient to retain, motivate and adequately award the executives.

Equity awards will be granted through the 2007 Performance Equity Plan, which was adopted by the Company's Board and was approved by the stockholders for their consideration at the special meeting. The 2007 Performance Equity Plan reserves 7.7 million shares of common stock for issuance in accordance with its terms. All employees, directors, officers and consultants will be eligible to participate in the 2007 Performance Equity Plan. The material terms of the 2007 Performance Equity Plan are further described in the section of the definitive proxy statement entitled "2007 Performance Equity Plan Proposal" filed with the SEC on November 28, 2007. On April 17, 2008, approximately 0.03 million

shares of common stock having an aggregate value of \$0.4

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million were granted to seven non-employee directors in accordance with the Closing of the Merger. The value of the stock award was based upon the December 12, 2007 closing price per share of \$15.60. On August 14, 2008, approximately 1.9 million shares of common stock having an aggregate value of \$12.1 million was awarded to eligible manufacturing employees. Of the \$12.1 million, \$5.2 million was withheld for payment of employment and withholding taxes, approximately 1.1 million shares with an aggregate value of \$6.9 million were issued to employees and cash was paid to employees in lieu of the issuance of fractional shares. The value of the stock award was based upon the August 14, 2008 closing price per share of \$6.54. As of September 30, 2008, the Company has not granted any stock awards under the 2007 Performance Equity Plan, other than to manufacturing employees and non-employee directors, as described above. As of September 30, 2008, approximately 5.8 million shares of the Company's common stock are available for future grants under the 2007 Performance Equity Plan, of which an estimated 0.9 million shares of common stock will be awarded to eligible employees.

Any equity compensation expense will be accounted for under the rules of SFAS No. 123R, which requires a company to estimate and record an expense for each award of equity compensation over the service period of the award. Accounting rules also will require the Company to record cash compensation as an expense at the time the obligation is accrued.

**Three Months Ended September 30, 2008 compared to the Three Months Ended September 30, 2007****Condensed Consolidated Statements of Income (unaudited)**

(Amounts in thousands, except per share amounts)

|  | Three Months Ended September 30<br>2008 |             | Three Months Ended September 30<br>2007 |              |
|--|---|-------------|---|--------------|
|  | Amount                                  | %           | Amount                                  | %            |
| Net sales                                  | \$ 154,801                              | 100.0%      | \$ 106,620                              | 100.0%       |
| Cost of sales                              | 77,179                                  | 49.9%       | 47,760                                  | 44.8%        |
| Gross profit                               | 77,622                                  | 50.1%       | 58,860                                  | 55.2%        |
| Operating expenses                         | 70,780                                  | 45.7%       | 47,148                                  | 44.2%        |
| <b>INCOME FROM OPERATIONS</b>              | <b>6,842</b>                            | <b>4.4%</b> | <b>11,712</b>                           | <b>11.0%</b> |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b> |   |             |   |              |
| Interest expense                           | 3,237                                   | 2.1%        | 4,397                                   | 4.1%         |
| Foreign currency transaction loss (gain)   | 1,049                                   | 0.7%        | (271)                                   | (0.2)%       |
| Other income                               | (636)                                   | (0.4)%      | (539)                                   | (0.5)%       |
| <b>INCOME BEFORE INCOME TAXES</b>          | <b>3,192</b>                            | <b>2.1%</b> | <b>8,125</b>                            | <b>7.6%</b>  |
| Income tax provision                       | 859                                     | 0.6%        | 2,118                                   | 2.0%         |
| <b>NET INCOME</b>                          | <b>\$ 2,333</b>                         | <b>1.5%</b> | <b>\$ 6,007</b>                         | <b>5.6%</b>  |

**PRO FORMA COMPUTATION RELATED TO CONVERSION TO C CORPORATION FOR INCOME TAX PURPOSES**

|                                       |          |      |
|---------------------------------------|----------|------|
| Historical income before income taxes | \$ 8,125 | 7.6% |
| Pro forma provision for income taxes  | 3,097    | 2.9% |
| Pro forma net income                  | \$ 5,028 | 4.7% |
| Proforma basic earnings per share     | \$ .10   |      |
| Proforma diluted earnings per share   | \$ .10   |      |



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**NET SALES:** The following table sets forth the Company's net sales for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007, and provides key breakdowns within each segment of significant net sales growth from period to period. Net sales were as follows:

|                               | September 30, 2008 |                | September 30, 2007 |                | Change    |       |
|-------------------------------|--------------------|----------------|--------------------|----------------|-----------|-------|
|                               | Amount             | % of net sales | Amount             | % of net sales | Amount    | %     |
| <b>Three Months Ended</b>     |                    |                |                    |                |           |       |
| <b>(Dollars in Thousands)</b> |                    |                |                    |                |           |       |
| <b>NET SALES</b>              |                    |                |                    |                |           |       |
| U.S. Wholesale                | \$ 46,219          | 29.9%          | \$ 40,092          | 37.6%          | \$ 6,127  | 15.3% |
| U.S. Retail                   | 46,675             | 30.2%          | 31,432             | 29.5%          | 15,243    | 48.5% |
| Canada                        | 19,874             | 12.8%          | 12,195             | 11.4%          | 7,679     | 63.0% |
| International                 | 42,033             | 27.1%          | 22,901             | 21.5%          | 19,132    | 83.5% |
| Total net sales               | \$ 154,801         | 100.0%         | \$ 106,620         | 100.0%         | \$ 48,181 | 45.2% |

Net sales increased \$48.2 million, or 45.2%, from \$106.6 million for the three months ended September 30, 2007 to \$154.8 million for the three months ended September 30, 2008.

A significant factor contributing to the growth in net sales period to period was the expansion of the Company's retail operations in the U.S. Retail segment, Canada segment and International segment. This was evidenced by the net increase of 74 new retail stores comprising a net increase of 34 new retail stores in the U.S. Retail segment, 9 new retail stores in the Canada segment, and 31 new retail stores in the International segment during the period from July 1, 2007 through September 30, 2008. Additionally, the Company's net sales from comparable stores increased 24% for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The Company's net sales in the U.S. Retail segment also increased due to the increased focus on building brand awareness and targeted advertising campaigns in the Company's retail business in the U.S. as further described below.

**U.S. Wholesale:** Net sales for the U.S. Wholesale segment increased \$6.1 million, or 15.3%, from \$40.1 million for the three months ended September 30, 2007 to \$46.2 million for the three months ended September 30, 2008. This increase was partly due to an increase in online sales due to strategic advertising and increased brand awareness. Online sales increased \$2.8 million from \$4.4 million for the three months ended September 30, 2007 to \$7.2 million for the three months ended September 30, 2008. Sales also increased as a result of organic growth in the wholesale business. One of the primary drivers behind the increase in U.S. Wholesale sales was the Company's ability to meet customer demand through increased stock of inventory on hand. During the three months ended September 30, 2008, the Company went through a phase of increased production in order to meet customer demand for the peak sales season which occurs during the summer months of the second and third quarters.

**U.S. Retail:** Net sales for the U.S. Retail segment increased \$15.2 million, or 48.5%, from \$31.4 million for the three months ended September 30, 2007 to \$46.7 million for the three months ended September 30, 2008. Growth was fueled by the increased number of retail stores in key markets in 2008 as compared to the same period in 2007. The number of open retail stores increased to 129 retail stores as of September 30, 2008 from 96 retail stores as of September 30, 2007. Comparable store sales in the U.S. Retail segment increased 24%, for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The increase in comparable store sales was primarily the result of increased brand awareness and higher sales volumes. Comparable store sales are calculated as the sales increase over the prior year comparable period for stores that have been open for at least twelve months.

**Canada:** Net sales for the Canada segment increased \$7.7 million, or 63.0%, from \$12.2 million for the three months ended September 30, 2007 to \$19.9 million for the three months ended September 30, 2008. This was a result of the addition of 9 new retail stores in key markets in Canada, as well as a 39% increase in comparable store sales in the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The number of open retail stores increased to 34 retail stores as of September 30, 2008 from 25 retail stores as of September 30, 2007. The increase in comparable store sales was primarily the result of increased brand awareness and higher sales volumes. Canada wholesale and online sales increased \$0.5 million, or 17%, from \$3.5 million for the three months ended September 30, 2007 to \$4.0 million for the three months ended September 30, 2008. This increase was attributed to the Company's increased efforts to expand the Company's wholesale and online customer base in Canada.

**International:** Net sales for the International segment increased \$19.1 million, or 83.5%, from \$22.9 million for the three months ended September 30, 2007 to \$42.0 million for the three months ended September 30, 2008. This increase was primarily due to the net increase of 23

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retail stores in the International segment, from 42 retail stores as of September 30, 2007 to 65 retail stores as of September 30, 2008. Comparable store sales in the International segment increased 17% for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. In the three months ended September 30, 2008, the Company opened 9 new stores in Australia, Brazil, China, Israel, Mexico, Switzerland and the United Kingdom. During the three months ended September 30, 2008, approximately \$3.8 million and \$3.3 million of sales were generated by wholesale and online sales, respectively, compared with \$2.4 million and \$1.7 million of sales generated by wholesale and online sales, respectively, for the



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three months ended September 30, 2007. The decrease in wholesale sales was due to reduced wholesale operations in Asia while the increase in online sales was attributable to increased brand awareness in international markets.

**Cost of Sales:** Cost of sales increased as a percentage of net sales from 44.8% for the three months ended September 30, 2007 to 49.9% for the three months ended September 30, 2008. This increase was primarily due to the recording \$12.1 million of share based compensation expense related to the stock award of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008 and \$1.1 million of employer related payroll taxes in cost of sales for the three months ended September 30, 2008. The \$13.2 million of expenses related to the stock award increased our cost of sales as a percentage of net sales by 8.5%. Excluding the impact of the aforementioned expenses related to the stock award, our cost of sales as a percentage of net sales decreased from 44.8% for the three months ended September 30, 2007 to 41.4% for the three months ended September 30, 2008. The decrease in cost of sales as a percentage of net sales was primarily attributed to change in the overall sales mix during the three months ended September 30, 2008 which included a higher level of retail sales as a result of the expansion of the retail business in the U.S. Retail, Canada and International segments which generate a higher gross margin than the U.S. Wholesale segment. Cost of sales was also favorably impacted from a reduction in inventory reserves of \$1.1 million which decreased our cost of sales as a percentage of net sales by 0.7% during the three months ended September 30, 2008. The reduction in the inventory reserve was the result of the opening of two closeout stores in key markets and expansion of certain existing closeout stores to increase inventory for sale. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores, resulting in higher inventory turnover of potentially obsolete inventory.

During three months ended September 30, 2008, the Company hired approximately 800 additional manufacturing employees to support the anticipated increase in demand for the Company's products throughout the remainder of 2008. Related to this activity, the Company incurred additional recruiting and training costs. Based on the Company's prior experience with hiring new employees, it is expected that the productivity of new employees reaches a normalized level within 90-120 days from the date of hire. Typically, gross margins in the U.S. Wholesale segment have been negatively impacted during periods where the Company has undergone an increased level of hiring.

Freight and duty costs increased by \$3.5 million during the three months ended September 30, 2008 largely as a result of increased transportation costs as a result of higher fuel costs and higher sales volumes.

**Gross profit:** Gross profit percentage decreased from 55.2% of net sales for the three months ended September 30, 2007 to 50.1% of net sales for the three months ended September 30, 2008. Gross margin was negatively impacted by the \$13.2 million of expenses from the stock award to manufacturing employees and related employer payroll taxes. The \$13.2 million of expenses decreased our gross margin by 8.5%. Excluding the impact of the aforementioned expenses related to the stock award, our gross margin increased from 55.2% for the three months ended September 30, 2007 to 58.6% for the three months ended September 30, 2008. The increase in our gross margin was due to an increase in the mix of sales coming from retail sales versus wholesale and an increase in online consumer sales. Gross profit was also favorably impacted from a reduction in inventory reserves of \$1.1 million which increased our gross profit percentage by 0.7% during the three months ended September 30, 2008. The reduction in the inventory reserve was primarily the result of the opening of two closeout stores in key markets and expansion of certain existing closeout stores to increase inventory for sale. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores, resulting in higher inventory turnover of potentially obsolete inventory. These benefits were partially offset by the hiring of additional manufacturing employees, as described above, to support increased production which continued through the third quarter ended September 30, 2008.

**OPERATING EXPENSES:** The following table sets forth the Company's operating expenses for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007 (dollars in thousands).

|                            | September 30, 2008 |                         | September 30, 2007 |                         | Change    |           |
|----------------------------|--------------------|-------------------------|--------------------|-------------------------|-----------|-----------|
|                            | Amount             | % of operating expenses | Amount             | % of operating expenses | Amount    | %         |
|                            | Selling            | \$ 46,173               | 65.2%              | \$ 29,964               | 63.6%     | \$ 16,209 |
| Warehouse and Distribution | 4,323              | 6.1%                    | 2,949              | 6.3%                    | 1,374     | 46.6%     |
| General and Administrative | 20,284             | 28.7%                   | 14,235             | 30.1%                   | 6,049     | 42.5%     |
| Total operating expenses   | \$ 70,780          | 100.0%                  | \$ 47,148          | 100.0%                  | \$ 23,632 | 50.1%     |

**Operating Expenses:** Operating expenses increased \$23.6 million, or 50.1%, from \$47.1 million for the three months ended September 30, 2007 to \$70.8 million for the three months ended September 30, 2008. Operating expenses include:

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**Selling Expenses:** Selling expenses together with unallocated corporate selling, advertising and promotion expenses, for the three months ended September 30, 2008 were \$46.2 million, which represented 29.8% of net sales, as compared to \$30.0 million for

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the three months ended September 30, 2007, which represented 28.1% of net sales. Increases in selling expenses are due to the increase in worldwide retail store locations as well as the strategic promotional advertising of the Company's products throughout all of its segments.

Advertising costs attributable as selling expenses for the three months ended September 30, 2008 were \$5.5 million, representing 3.3% of net sales, compared with \$3.6 million, or 3.4% of net sales for the three months ended September 30, 2007. Advertising costs increased \$1.5 million mainly due to expenses incurred to promote the Company's brand and products primarily online, but also through print media.

The number of open stores increased from 163 as of September 30, 2007 to 228 as of September 30, 2008, resulting in an increase in rent and occupancy costs of \$5.7 million. Payroll costs increased from \$12.1 million for the three months ended September 30, 2007 to \$18.9 million for the three months ended September 30, 2008, for an increase of \$6.8 million. This increase in payroll costs was a result of increased staffing levels to support the increased number of stores and higher sales volumes at existing stores. The Company also increased compensation to certain valued employees, as the Company believes that it must provide competitive compensation opportunities so that it can attract, motivate and retain qualified employees.

Costs related to preparing for opening new stores include materials, pre-opening labor and training, utilities, travel, rent and, IT labor and costs. Pre-opening costs for the U.S. Retail segment were \$2.9 million for the three months ended September 30, 2008 compared to \$0.2 million for the three months ended September 30, 2007. Canadian segment had a total of \$0.2 million in pre-opening expenses for the three months ended September 30, 2008 compared to no pre-opening expenses for the three months ended September 30, 2007. There was a total of \$1.3 million in pre-opening expenses in the International segment for the three months ended September 30, 2008 compared to \$0.7 million for the three months ended September 30, 2007.

**Warehouse and Distribution Expenses:** Warehouse and distribution expenses for the three months ended September 30, 2008 were \$4.3 million as compared to \$2.9 million for the three months ended September 30, 2007; an increase of \$1.4 million or 46.6%. These expenses represented 2.8% of the total net sales for each of the three months ended September 30, 2008 and 2007. The increase in warehouse and distribution expense is attributable to increases of \$1.1 million in staffing expenses necessary to support increased volume and sales growth primarily in the retail business.

**General and Administrative Expenses:** General and administrative expenses for the three months ended September 30, 2008 were \$20.3 million, as compared to \$14.2 million for the three months ended September 30, 2007, an increase of \$6.1 million or 42.5%. General and administrative expenses represented 13.1% and 13.4% of total net sales for the three months ended September 30, 2008 and 2007, respectively.

General and administrative expenses increased by approximately \$2.9 million due to an increase in corporate overhead and \$3.9 million due to growth in the administrative structure required to support the growth in the Company's retail business in the U.S. Retail, Canada and International segments. The total number of retail stores increased from 163 opened stores at September 30, 2007 to 228 opened stores at September 30, 2008.

Corporate overhead expenses for the three months ended September 30, 2008 were increased to \$9.4 million, as compared to \$6.5 million for the three months ended September 30, 2007, an increase of \$2.9 million. The increase in corporate overhead expenses was the result of additional expenses for higher salaries and payroll related expenses and professional fees due to increased staffing and the regulatory environment of operating as a public company in 2008. Of the \$2.9 million increase in corporate expenses, salaries and payroll related expenses increased by \$0.6 million, professional and consulting fees increased by \$1.4 million and the remaining \$0.9 million increase was primarily due to an increase in information technology, web development and other office related expenses. Salaries and payroll related expenses were \$2.7 million and \$2.1 million for the three months ended September 30, 2008 and 2007, respectively. Professional and consulting fees were \$2.6 million and \$1.2 million for the three months ended September 30, 2008 and 2007, respectively. The \$1.4 million increase in professional and consulting fees primarily related to an increase of \$0.8 million in accounting fees directly related to public company reporting and compliance requirements, \$0.2 million in legal fees and \$0.4 million in consulting fees related to review work required under the Sarbanes-Oxley Act of 2002 and other initiatives.

**Interest Expense:** The major components of interest expense for the three months ended September 30, 2008 consisted of interest on the outstanding revolving credit facility, loans from related and unrelated parties and a term loan from a private investment firm. The Company used proceeds from the exercise of the warrants in the first quarter of 2008 to reduce the level of debt outstanding. The reduction in the level of debt resulted in a \$1.2 million decrease in interest expense from \$4.4 million for the three months ended September 30, 2007 to \$3.2 million for the three months ended September 30, 2008. Interest rates on debt ranged from 3% to 26% during the three months ended September 30, 2008. Interest expense represented 2.1% and 4.1% of the total net sales for the three months ended September 30, 2008 and 2007, respectively. The net decrease in interest expense was also attributable to the decreased LIBOR rate in the three months ended September 30, 2008. Interest expense also included approximately \$0.8 million of loan fees, consisting of waiver fees and legal fees relating to renegotiating the terms of the Company's credit agreements.



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**Other Income (Expense):** Other income was \$0.6 million for the three months ended September 30, 2008 as compared \$0.5 million for the three months ended September 30, 2007. Other income represented 0.4% of the total net sales for the three months ended September 30, 2008 as compared to 0.5% for the three months ended September 30, 2007.

**Income Taxes:** Income tax provision decreased from \$2.1 million for the three months ended September 30, 2007 to \$0.9 million for the three months ended September 30, 2008.

Prior to July 1, 2004, Old American Apparel operated as a C corporation under U.S. tax law. Effective July 1, 2004, the stockholders elected to be taxed under Subchapter S of the Internal Revenue Code (the "S Corporation Election"). During the period of the S Corporation Election, federal income taxes and certain state taxes were the responsibility of Old American Apparel's stockholders. The S Corporation Election terminated with the consummation of the Merger on December 12, 2007. As a result of the change of Old American Apparel's S corporation status for U.S. tax purposes to the C corporation status on December 12, 2007, the deferred tax assets and liabilities were adjusted to reflect the change in federal and state tax rates applicable to C corporations.

Where applicable, state income taxes are provided by the Company at the applicable statutory rates multiplied by pre-tax income. The Company and its subsidiaries file income tax returns in various states and foreign jurisdictions.

**Net Income:** The Company's net income for the three months ended September 30, 2008 decreased by approximately \$3.7 million from the net income for the three months ended September 30, 2007 due to the various factors described above.

For the three months ended September 30, 2008 and 2007, American Apparel's basic and diluted earnings per share was approximately \$0.03 and \$0.12, respectively. The number of shares outstanding changed in 2008 due to the redemption of approximately 16.2 million warrants into approximately 13.5 million shares of common stock, issuance of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008, and the repurchase of approximately 1.4 million shares of common stock during the second quarter of 2008.

**Nine Months Ended September 30, 2008 compared to the Nine Months Ended September 30, 2007****Condensed Consolidated Statements of Income (unaudited)****(Dollars in Thousands, except per share amounts)**

|  | <b>Nine Months Ended September 30</b> |             |                  |              |
|--|---------------------------------------|-------------|------------------|--------------|
|  | <b>2008</b>                           |             | <b>2007</b>      |              |
|  | <b>Amount</b>                         | <b>%</b>    | <b>Amount</b>    | <b>%</b>     |
| Net sales                                  | \$ 399,406                            | 100.0%      | \$ 275,853       | 100.0%       |
| Cost of sales                              | 180,965                               | 45.3%       | 120,435          | 43.7%        |
| Gross profit                               | 218,441                               | 54.7%       | 155,418          | 56.3%        |
| Operating expenses                         | 191,606                               | 48.0%       | 124,932          | 45.3%        |
| <b>INCOME FROM OPERATIONS</b>              | <b>26,835</b>                         | <b>6.7%</b> | <b>30,486</b>    | <b>11.0%</b> |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b> |                                       |             |                  |              |
| Interest expense                           | 10,274                                | 2.6%        | 13,149           | 4.8%         |
| Foreign currency transaction loss          | 1,047                                 | 0.3%        | 453              | 0.1%         |
| Other expense (income)                     | 133                                   | 0.0%        | (1,081)          | (0.4)%       |
| <b>INCOME BEFORE INCOME TAXES</b>          | <b>15,381</b>                         | <b>3.9%</b> | <b>17,965</b>    | <b>6.5%</b>  |
| Income tax provision                       | 5,153                                 | 1.3%        | 5,482            | 2.0%         |
| <b>NET INCOME</b>                          | <b>\$ 10,228</b>                      | <b>2.6%</b> | <b>\$ 12,483</b> | <b>4.5%</b>  |

**PRO FORMA COMPUTATION RELATED TO CONVERSION TO C CORPORATION  
FOR INCOME TAX PURPOSES**

|                                       |           |      |
|---------------------------------------|-----------|------|
| Historical income before income taxes | \$ 17,965 | 6.5% |
| Pro forma provision for income taxes  | 6,848     | 2.5% |
| Pro forma net income                  | \$ 11,117 | 4.0% |
| Pro forma basic earnings per share    | \$ .23    |      |
| Pro forma diluted earnings per share  | \$ .23    |      |

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**NET SALES:** The following table sets forth the Company's net sales for the nine months ended September 30, 2008 as compared to September 30, 2007, and provides key breakdowns within each segment of significant net sales growth from period to period. Net sales were as follows:

|                  | Nine Months Ended      |                |                    |                | Change     |       |
|------------------|------------------------|----------------|--------------------|----------------|------------|-------|
|                  | September 30, 2008     |                | September 30, 2007 |                | Amount     | %     |
|                  | Amount                 | % of net sales | Amount             | % of net sales |            |       |
|                  | (Dollars in Thousands) |                |                    |                |            |       |
| <b>NET SALES</b> |                        |                |                    |                |            |       |
| U.S. Wholesale   | \$ 124,665             | 31.2%          | \$ 106,466         | 38.6%          | \$ 18,199  | 17.1% |
| U.S. Retail      | 118,838                | 29.8%          | 80,411             | 29.1%          | 38,427     | 47.8% |
| Canada           | 48,549                 | 12.2%          | 30,234             | 11.0%          | 18,315     | 60.6% |
| International    | 107,354                | 26.8%          | 58,742             | 21.3%          | 48,612     | 82.8% |
| Total net sales  | \$ 399,406             | 100.0%         | \$ 275,853         | 100.0%         | \$ 123,553 | 44.8% |

Net sales increased \$123.6 million, or 44.8%, from \$275.9 million for the nine months ended September 30, 2007 to \$399.4 million for the nine months ended September 30, 2008.

A significant factor contributing to the growth in net sales period to period was the expansion of the Company's retail operations in the U.S. Retail segment, the Canada segment and the International segment. This was evidenced by the net increase of 65 new retail stores comprising a net increase of 33 new retail stores in the U.S. Retail segment, 9 new retail stores in the Canada segment, and 23 new retail stores in the International segment during the period October 1, 2007 through September 30, 2008. Additionally, the Company's net sales from comparable stores increased 27% for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. Also of primary significance to the expansion of American Apparel's retail business in the U.S. was the Company's increased focus on building brand awareness and targeted advertising campaigns as further described below.

**U.S. Wholesale:** Net sales for the U.S. Wholesale segment increased \$18.2 million, or 17.1%, from \$106.5 million for the nine months ended September 30, 2007 to \$124.7 million for the nine months ended September 30, 2008. This increase was partly due to an increase in online sales due to strategic advertising and increased brand awareness. Online sales increased from \$11.0 million for the nine months ended September 30, 2007 to \$17.9 million for the nine months ended September 30, 2008. Sales also increased as a result of organic growth in the wholesale business. One of the primary drivers behind the increase in U.S. Wholesale sales was the Company's ability to meet customer demand through increased stock of inventory on hand. During the nine months ended September 30, 2008, the Company went through a phase of increased production in order to meet customer demand during the peak sales season.

**U.S. Retail:** Net sales for the U.S. Retail segment increased \$38.4 million, or 47.8%, from \$80.4 million for the nine months ended September 30, 2007 to \$118.8 million for the nine months ended September 30, 2008. Growth was fueled by the increased number of retail stores in key markets in 2008 as compared to the same period in 2007. The number of open retail stores increased to 129 retail stores as of September 30, 2008 from 96 retail stores as of September 30, 2007. Comparable store sales in the U.S. Retail segment increased 29% for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. The increase in comparable store sales was primarily the result of increased brand awareness and higher sales volumes. Comparable store sales are calculated as the sales increase over the prior year comparable period for stores that have been open at least 12 months.

**Canada:** Net sales for the Canada segment increased \$18.3 million, or 60.6%, from \$30.2 million for the nine months ended September 30, 2007 to \$48.5 million for the nine months ended September 30, 2008. This was a result of the addition of new retail stores in key markets in Canada, as well as a 38% increase in comparable store sales in the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. The number of open retail stores increased to 34 retail stores as of September 30, 2008 from 25 retail stores as of September 30, 2007. The increase in comparable store sales was primarily the result of increased brand awareness and higher sales volumes. Canada wholesale and online sales increased \$1.7 million, or 18%, from \$9.3 million for the nine months ended September 30, 2007 to \$11.0 million for the nine months ended September 30, 2008. This increase was attributed to the Company's increased efforts to expand the Company's wholesale customer base in Canada.

**International:** Net sales for the International segment increased \$48.6 million, or 82.8%, from \$58.7 million for the nine months ended September 30, 2007 to \$107.4 million for the nine months ended September 30, 2008. This increase was primarily due to the net increase of 23 retail stores in the International segment, from 42 retail stores as of September 30, 2007 to 65 retail stores as of September 30, 2008. Comparable

store sales in the International segment increased 18% for the nine months ended September 30,



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2008 as compared to the nine months ended September 30, 2007. In the nine months ended September 30, 2008, the Company opened 18 new stores in Australia, Belgium, Brazil, China, France, Germany, Israel, Italy, Japan, Korea, Mexico, Netherlands, Spain, Switzerland and the United Kingdom. During the nine months ended September 30, 2008, approximately \$11.6 million and \$8.9 million of the sales were generated by wholesale and online sales, respectively, compared with \$9.2 million and \$4.1 million for wholesale and online sales, respectively, for the nine months ended September 30, 2007.

**Cost of Sales:** Cost of sales as a percentage of net sales was 45.3% and 43.7% for the nine month periods ended September 30, 2008 and 2007, respectively. The increase was primarily due to the recording \$12.1 million of share based compensation expense related to the stock award of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008 and \$1.1 million of employer related payroll taxes in cost of sales for the nine months ended September 30, 2008. The \$13.2 million of expenses related to the stock award increased our cost of sales as a percentage of net sales by 3.3%. Excluding the impact of the aforementioned expenses related to the stock award, our cost of sales as a percentage of net sales decreased from 43.7% for the nine months ended September 30, 2007 to 42.0% for the nine months ended September 30, 2008. The decrease in cost of sales as a percentage of net sales was primarily due to the change in the overall sales mix during the nine months ended September 30, 2008 which included a higher level of online sales and retail sales as a result of the expansion of the retail business in the U.S. Retail, Canada, and International segments which generate higher gross margins than the U.S. Wholesale segment.

During the nine months ended September 30, 2008, the Company hired approximately 2,100 additional manufacturing employees to support the anticipated increase in demand for the Company's products throughout the remainder of 2008. Related to this activity, the Company incurred additional recruiting and training costs. Based on the Company's prior experience with hiring new employees, it is expected that the productivity of new employees reaches a normalized level within 90-120 days of the date of hire. Typically, gross margins in the U.S. wholesale segment have been negatively impacted during periods where the Company has undergone an increased level of hiring.

Freight and duty costs increased by \$8.9 million during the nine months ended September 30, 2008 largely as a result of increased transportation costs.

To supplement the Company's in-house production capacity in December 2007, the Company acquired a new garment dyeing and finishing facility, which began operations in 2008. The new dyeing and finishing facility in South Gate, California is capable of dyeing completely sewn garments and the purchase of these assets added garment dyeing capability to the Company's production process. The new facility began production in January 2008 and will further enhance the Company's capability for in-house quality control. This acquisition included the assumption of the lease for the facility as well as the purchase of all of the tangible personal property at the plant. Startup expenses typically associated with manufacturing at new facilities resulted in approximately \$0.9 million charges in cost of sales, attributable largely to the fact that, at this location, the Company is beginning to manufacture certain denim based new styles which are more costly to manufacture. The \$0.9 million of additional cost of sales charges represents approximately 0.7% of the total increase in cost of sales.

To further supplement the Company's in-house production capacity, in May 2008, the Company acquired an existing fabric dyeing and finishing facility in Garden Grove, California. In addition to providing substantial new dyeing capacity, the facility has available production space in which the Company is adding knitting capacity. The facility was formerly a contract dyeing vendor for the Company, and operations were not interrupted by the acquisition.

**Gross profit:** Gross profit percentage decreased from 56.3% of net sales for the for the nine months ended September 30, 2007 to 54.7% of net sales for the nine months ended September 30, 2008. Gross margin was negatively impacted by the \$13.2 million of expenses from the stock award to manufacturing employees and related employer payroll taxes. The \$13.2 million of expenses decreased our gross margin by 3.3%. Excluding the impact of the aforementioned expenses related to the stock award, our gross margin for the nine months ended September 30, 2008 increased from 56.3% for the nine months ended September 30, 2007 to 58.0% for the nine months ended September 30, 2008. The increase in our gross margin was primarily due to an increase in the mix of sales coming from retail sales versus wholesale, along with an increase in online consumer sales. This benefit was partially offset by the hiring of a significant number of new manufacturing employees to support increased production which continued through the third quarter.

**OPERATING EXPENSES:** The following table sets forth American Apparel's operating expenses for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007 (dollars in thousands).

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|                            | Nine Months Ended  |                         |                    |                         | Change    |       |
|----------------------------|--------------------|-------------------------|--------------------|-------------------------|-----------|-------|
|                            | September 30, 2008 |                         | September 30, 2007 |                         | Amount    | %     |
|                            | Amount             | % of operating expenses | Amount             | % of operating expenses |           |       |
| Selling                    | \$ 122,212         | 63.8%                   | \$ 79,924          | 64.0%                   | \$ 42,288 | 52.9% |
| Warehouse and Distribution | 11,559             | 6.0%                    | 7,202              | 5.8%                    | 4,357     | 60.5% |
| General and Administrative | 57,835             | 30.2%                   | 37,806             | 30.2%                   | 20,029    | 53.0% |
| Total operating expenses   | \$ 191,606         | 100.0%                  | \$ 124,932         | 100.0%                  | \$ 66,674 | 53.4% |

**Operating Expenses:** Operating expenses increased from \$124.9 million for the nine months ended September 30, 2007 to \$191.6 million for the nine months ended September 30, 2008, which represents an increase of \$66.7 million or 53.4%. Operating expenses include:

**Selling Expenses:** Selling expenses together with unallocated corporate selling, advertising and promotion expenses, for the nine months ended September 30, 2008 were \$122.2 million, which represented 30.6% of net sales, as compared to \$79.9 million for the nine months ended September 30, 2007, which represented 29.0% of net sales. Increases in selling expenses are due to the increase in worldwide retail store locations as well as the strategic promotional advertising of the Company's products throughout all of its segments.

Advertising costs attributable as selling expenses for the nine months ended September 30, 2008 were \$14.6 million, representing 3.7% of net sales, compared with \$8.3 million, or 3.0% of net sales for the nine months ended September 30, 2007. Advertising costs increased \$6.3 million mainly due to expenses incurred to promote new store openings and to promote the Company's brand and products, primarily online, but also through print media.

The number of open stores increased from 163 as of September 30, 2007 to 228 as of September 30, 2008, resulting in an increase in rent and occupancy costs of \$12.7 million during the nine months ended September 30, 2008. Payroll costs increased from \$33.4 million for the nine months ended September 30, 2007 to \$49.5 million for the nine months ended September 30, 2008, for an increase of \$16.1 million. This increase in payroll costs was a result of increased staffing levels to support the increased number of stores and higher sales volumes at existing stores. The Company also increased compensation to certain valued employees, as the Company believes that it must provide competitive compensation opportunities so that it can attract, motivate and retain qualified employees.

Costs related to preparing for opening new stores include materials, pre-opening labor and training, utilities, travel, rent and IT labor and costs. Pre-opening costs for the U.S. Retail segment were \$4.7 million for the nine months ended September 30, 2008 compared to \$0.8 million for the nine months ended September 30, 2007. Canadian segment had a total of \$0.4 million in pre-opening expenses for the nine months ended September 30, 2008 compared to no pre-opening expenses for the nine months ended September 30, 2007. There was a total of \$3.2 million in pre-opening expenses in the International segment for the nine months ended September 30, 2008 compared to \$2.9 million for the nine months ended September 30, 2007.

**Warehouse and Distribution Expenses:** Warehouse and distribution expenses for the nine months ended September 30, 2008 were \$11.6 million as compared to \$7.2 million for the nine months ended September 30, 2007, an increase of \$4.4 million or 60.5%. These expenses represented 2.9% and 2.6%, respectively, of the total net sales for the nine months ended September 30, 2008 and 2007. The increase in warehouse and distribution expense is attributable to increases of \$3.8 million in staffing expenses necessary to support increased volume and sales growth, primarily in the retail business.

**General and Administrative Expenses:** General and administrative expenses for the nine months ended September 30, 2008 were \$57.8 million, as compared to \$37.8 million for the nine months ended September 30, 2007, an increase of \$20.0 million or 53.0%. General and administrative expenses represented 14.5% and 13.7% of total net sales for the nine months ended September 30, 2008 and 2007, respectively.

General and administrative expenses increased by approximately \$10.1 million due to an increase in corporate overhead and \$11.2 million due to growth in the administrative structure required to support the growth in the company's retail business in the U.S. Retail, Canada and International segments. The total number of retail stores increased from 163 opened stores at September 30, 2007 to 228 opened stores at September 30, 2008.

Corporate overhead expenses for the nine months ended September 30, 2008 increased to \$28.5 million, as compared to \$18.4 million for the nine months ended September 30, 2007, an increase of \$10.1 million. The increase in corporate overhead expenses was the result of additional expenses for higher salaries and payroll related expenses and professional fees due to increased staffing and the regulatory environment of operating as a public company in 2008. Of the \$10.1 million increase in corporate expenses, salaries and payroll related expenses increased by \$1.7 million, professional and consulting fees increased by \$5.5 million, directors compensation and fees increased by \$0.6 million and the remaining \$2.3 million increase was primarily due to an increase in



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information technology and web development expenses. Salaries and payroll related expenses were \$8.0 million and \$6.3 million for the nine months ended September 30, 2008 and 2007, respectively. Professional and consulting fees were \$9.1 million and \$3.7 million for the nine months ended September 30, 2008 and 2007, respectively. The \$5.4 million increase in professional and consulting fees primarily related to an increase of \$2.0 million in accounting fees directly related to public company reporting and compliance requirements, \$2.3 million in legal fees and \$1.1 million in consulting fees related to review work required under the Sarbanes-Oxley Act of 2002 and other initiatives. Directors compensation and fees included expenses of \$0.4 million in connection with the grant of common shares pursuant to the 2007 Performance Equity Plan. The initial stock grants, due as of the closing of the Acquisition, were approved by the Board of Directors on February 6, 2008 and the number of shares awarded to each non-employee director was determined using the highest closing price per share of common stock as of December 12, 2007, February 6, 2008 and April 17, 2008. Consequently, each non-employee director was granted 4,808 shares of common stock based upon the December 12, 2007 closing price per share of \$15.60. The compensation expense associated with the share awards has been accrued as of the nine months ended September 30, 2008 and is based upon the February 6, 2008 closing price per share of \$12.85.

**Interest Expense:** The major components of interest expense for the nine months ended September 30, 2008 consisted of interest on the outstanding revolving credit facility, loans from related and unrelated parties and a term loan from a private investment firm. The Company used proceeds from the exercise of the warrants in the first quarter of 2008 to reduce the level of debt outstanding. The reduction in the level of debt resulted in a \$2.8 million decrease in interest expense from \$13.1 million for the nine months ended September 30, 2007 to \$10.3 million for the nine months ended September 30, 2008. Interest rates on debt ranged from 6% to 21% during the nine months ended September 30, 2008. Interest expense represented 2.6% and 4.8% of the total net sales for the nine months ended September 30, 2008 and 2007, respectively. The net decrease in interest expense was also attributable to the decreased LIBOR rate in the nine months ended September 30, 2008. Interest expense also included approximately \$0.5 million of loan fees, consisting of waiver fees and legal fees relating to renegotiating the terms of the Company's Credit Agreement.

**Other (Income) Expense:** Other expense was \$0.1 million for the nine months ended September 30, 2008 as compared to other income of \$1.1 million for the nine months ended September 30, 2007. The increase in other (income) expense is attributable to tariff charges assessed and prior uncollected receivables. Other expense represented 0.0% of the total net sales for the nine months ended September 30, 2008 as compared to other income which represented 0.4% of the total net sales for the nine months ended September 30, 2007.

**Income Taxes :** Income tax provision decreased from \$5.5 million for the nine months ended September 30, 2007 to \$5.2 million for the nine months ended September 30, 2008.

Prior to July 1, 2004, Old American Apparel operated as a C corporation under U.S. tax law. Effective July 1, 2004, the stockholders elected to be taxed under Subchapter S of the Internal Revenue Code (the "S Corporation Election"). During the period of the S Corporation Election, federal income taxes and certain state taxes were the responsibility of Old American Apparel's stockholders. The S Corporation Election terminated with the consummation of the Merger on December 12, 2007. As a result of the change of Old American Apparel's S corporation status for U.S. tax purposes to the C corporation status on December 12, 2007, the deferred tax assets and liabilities were adjusted to reflect the change in federal and state tax rates applicable to C corporations.

Where applicable, state income taxes are provided by the Company at the applicable statutory rates multiplied by pre-tax income. The Company and its subsidiaries file income tax returns in various states and foreign jurisdictions.

**Net Income:** The Company's net income for the nine months ended September 30, 2008 decreased by approximately \$2.3 million from the net income for the nine months ended September 30, 2007 as a result of the various factors described above.

For the nine months ended September 30, 2008, American Apparel's basic and diluted earnings per share were approximately \$0.15 compared to \$0.26 for the nine month period ended September 30, 2007. The number of shares outstanding changed in 2008 due to the redemption of approximately 16.2 million warrants into approximately 13.5 million shares of common stock, issuance of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008, and the repurchase of approximately 1.4 million shares of common stock during the second quarter of 2008.

## **Liquidity and Capital Resources**

Over the past years, the Company's growth has been funded through a combination of borrowings from related and unrelated parties, bank debt and lease financing. As of September 30, 2008, American Apparel had approximately \$13.9 million in unrestricted cash. On January 18, 2007, the Company completed a \$41.0 million secured debt financing with SOF Investments. During July 2007, the Company executed an agreement to obtain an additional \$10 million in financing from SOF Investments. Also, during July 2007, the Company replaced its revolving credit facility of \$62.5 million with a revolving credit facility of \$75.0 million from LaSalle Bank.



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As of September 30, 2008, the Company had approximately \$13.9 million in unrestricted cash and \$7.1 million available under its revolving credit line. The outstanding balances were \$49.2 million under the revolving credit line and \$51.0 million under the private investment firm loan (the SOF Loan ) as of September 30, 2008. The SOF Loan is due January 18, 2009. The revolving credit line is due on the earlier of July 2, 2012 or December 19, 2008, the date thirty days prior to the due date of the SOF Loan, unless the SOF Loan is renewed under terms acceptable to the revolving credit line lenders. Accordingly, the aggregate amount outstanding balance of \$100.2 million from the SOF Loan and the revolving credit line are classified as current liabilities as of September 30, 2008.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50 million for the fiscal year ending December 31, 2008. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the Eighth Amendment ) with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74 million. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings.

The Company is evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement, which currently matures on January 18, 2009. If by December 19, 2008 the Company is unable to extend or renew the SOF Credit Agreement, or refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, all outstanding obligations under the LaSalle Credit Agreement will become due on December 19, 2008. If acceleration of debt obligations were to occur, we cannot be assured that we would be able to obtain alternative financing or that our assets would be sufficient to repay in full our obligations under our debt instruments. The acceleration of any or all amounts due under the SOF loan or other credit facilities could have a material adverse impact on our operations which could result in the need for the Company to modify its current business plan, curtail operations or affect the Company's ability to continue operations as a going concern.

In addition, the world financial markets have been experiencing volatility and disruption and many lenders and financial institutions have reduced or ceased to provide funding for borrowers. The availability of credit, confidence in the entire financial sector, and volatility in financial markets has been adversely affected. See Risk Factors for additional information.

On August 14, 2008, approximately 1.9 million shares of the common stock having an aggregate value of \$12.1 million was awarded to eligible manufacturing employees. Of the \$12.1 million, \$5.2 million was withheld for payment of employment and withholding taxes and approximately 1.1 million shares with an aggregate value of \$6.9 million were issued to employees and cash was paid to employees in lieu of the issuance of fractional shares. The value of the stock award was based upon the August 14, 2008 closing price per share of \$6.54 (date of grant).

On February 6, 2008 the Company called for redemption of all of its issued and outstanding Warrants. Prior to the redemption date of March 7, 2008, approximately 16.2 million of the warrants outstanding at December 31, 2007 were exercised. The remaining 0.01 million warrants were redeemed by the Company at a price of \$.01 per warrant. The net proceeds received by the Company from the warrant exercise amounted to approximately \$65.6 million.

Cash bonuses in an aggregate amount of \$2.5 million were awarded to non executive officers and certain employees of the Company in recognition of the contributions they made to the successful completion of the Merger and overall growth of the Company. This amount was accrued in the Company's financial statements as of December 31, 2007 and was paid during the nine months ended September 30, 2008.

## **Cash Flow Overview**

### **Nine Months Ended September 30, 2008**

For the nine months ended September 30, 2008, cash provided by operations was \$0.9 million. This is a result of net income before non-cash expenses (primarily depreciation and amortization, share-based compensation, foreign exchange transaction loss and deferred rent expense) of \$43.8 million and an increase in accounts payable and accrued expenses of \$20.9 million, offset by an increase in inventory of \$48.4 million, increase in receivables of \$4.2 million, and increase in prepaid expenses and other current assets of \$2.3 million. The increase in inventory levels during the first nine months of 2008 included raw material purchases and production of product to support American Apparel's growth in the U.S. Wholesale segment, expansion of the retail business in the U.S. Retail, Canada and International segments, and peak selling season that

generally occurs from the months of May through September.

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For the nine months ended September 30, 2008, American Apparel used \$55.6 million of cash in investing activities. This is partially a result of increased net investment in property and equipment for the U.S. Wholesale segment by approximately \$12.9 million and an increased investment in property and equipment of \$21.4 million for the U.S. Retail, \$3.2 million in the Canada segment, and \$14.5 million in the International segment.

For the nine months ended September 30, 2008, cash from financing activities was \$50.4 million. This is primarily the result the Company's principal capital requirements to fund working capital needs and to finance opening of new retail stores, as well as to finance purchases of new manufacturing and information systems equipment to support higher production levels and growth in online operations. Proceeds from exercise of warrants amounted to \$65.6 million offset by the \$10.0 million repurchase of treasury shares and \$5.2 million to satisfy the applicable income tax withholding obligations by a net share settlement which is deemed to be a repurchase by the Company of its common stock during the nine month period ended September 30, 2008.

The term loan with the SOF Investments is set to mature in January 2009, while the Company's secured revolving credit facility with LaSalle Bank of \$75.0 million matures on the earlier of July 2012 or December 19, 2008, the date thirty days prior to the maturity of the term loan with SOF Investments (unless the term loan is refinanced on terms acceptable to LaSalle Bank). However the Company was in violation of certain covenants during the quarter ended June 30, 2008. During May 2008 and June 2008, the Company received waivers of these covenant violations.

On June 20, 2008, the Registrant, in its capacity as Facility Guarantor, American Apparel (USA), LLC, a subsidiary of the Company, in its capacity as Lead Borrower, and certain other subsidiaries of the Company, in their capacities as Borrowers or Facility Guarantors, entered into a Fourth Amendment to Credit Agreement (the Fourth Amendment) with LaSalle Business Credit, LLC, LaSalle Bank National Association, Wells Fargo Retail Finance, LLC and the lenders party to the Credit Agreement, dated as of July 2, 2007 (as previously amended, the LaSalle Credit Agreement). Capitalized terms used but not defined in this description of the Fourth Amendment have the respective meanings set forth in the LaSalle Credit Agreement.

The Fourth Amendment amended the LaSalle Credit Agreement to, among other things: (i) delete financial covenants relating to minimum Consolidated EBITDA, maximum Capital Expenditures, Consolidated Fixed Charge Coverage Ratio, Senior Debt to Consolidated EBITDA ratio and Adjusted Debt to EBITDAR ratio; (ii) increase Minimum Excess Availability from \$3 million to 10% of the lesser of the Borrowing Base and the Revolving Credit Ceiling; (iii) increase the Permitted Indebtedness threshold for capital leases from \$15 million to \$20 million; (iv) permit the repurchase of up to \$30 million of the Loan Parties' capital stock if certain conditions are met; (v) provide additional flexibility for investing in foreign subsidiaries; (vi) add the Registrant as a Facility Guarantor; and (vii) increase from 2.00% to 2.50% the applicable margin for LIBOR-based borrowings and increase from zero to 0.50% the applicable margin for borrowings based on the bank's prime rate.

On June 20, 2008, the Registrant, in its capacity as a Facility Guarantor, American Apparel (USA), LLC, in its capacity as Borrower, and certain other subsidiaries of the Company, in their capacities as Facility Guarantors, entered into Amendment No. 7 to Credit Agreement (the Seventh Amendment) with SOF Investments, L.P. Private IV, as Lender, to amend the Credit Agreement, dated as of July 18, 2007 (as amended, the SOF Credit Agreement). Capitalized terms used but not defined in this description of the Seventh Amendment have the respective meanings set forth in the SOF Credit Agreement.

The Seventh Amendment amended the SOF Credit Agreement to, among other things: (i) measure financial covenants at the level of the Company instead of American Apparel (USA), LLC; (ii) delete the financial covenant relating to Consolidated Fixed Charge Coverage ratio; (iii) increase the Permitted Indebtedness threshold for capital leases from \$15 million to \$20 million; (iv) permit the repurchase of up to \$30.0 million of the Loan Parties' capital stock if certain conditions are met; (v) provide additional flexibility for investing in foreign subsidiaries; (vi) add the Registrant as a Facility Guarantor; (vii) increase the limit on Annual Capital Expenditures to \$50.0 million; and (viii) increase the level of Consolidated EBITDA required by the minimum Consolidated EBITDA covenant.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50 million for the fiscal year ending December 31, 2008. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the Eighth Amendment) with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74 million. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings.



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The Company is evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement, which currently matures on January 18, 2009. If by December 19, 2008 the Company is unable to extend or renew the SOF Credit Agreement, or refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, all outstanding obligations under the LaSalle Credit Agreement will become due on December 19, 2008.

**Table of Contents****Debt Agreements**

The following is an overview of American Apparel's long term and current debt as of September 30, 2008 (dollar amounts in thousands).

| Description of Debt                           | Lender Name                                      | Interest Rate  | September 30, 2008 | Covenant Violations | Reference |
|---|--|----------------|--------------------|---------------------|-----------|
| Revolving credit line                         | LaSalle Bank                                     | LIBOR + 2.5%   | \$ 49,249          | Yes                 | a         |
| Revolving credit line (Canada)                | Toronto Dominion Bank                            | Prime + 0.75%  | 1,060              |                     | b         |
| Term loan from private investment firm        | SOF Investments                                  | 16.0%          | 51,000             | Yes                 | c         |
| Other   |  |                | 703                |                     |           |
| <b>Total long term debt</b>                   |  |                | <b>\$ 102,012</b>  |                     |           |
| Less current portion of debt                  |  |                | (101,527)          |                     |           |
| <b>Long-term debt, net of current portion</b> |  |                | <b>\$ 485</b>      |                     |           |
| Capital lease obligations                     | 74 individual leases ranging between \$1 - \$428 | From 3% to 26% | 4,632              |                     | d         |
| Subordinated notes payable to related parties |  | 6%             | 5,923              |                     | e         |
| Cash overdraft                                |  |                | \$ 4,191           |                     |           |
| <b>Total debt</b>                             |  |                | <b>\$ 116,758</b>  |                     |           |

(a) At September 30, 2008, the Company's revolving credit facility with LaSalle Bank provided for borrowings up to \$75.0 million. Borrowings under the facility are subject to certain advance provisions established by the bank and are collateralized by substantially all assets of American Apparel. Interest under the agreement is at LIBOR (3.93% at September 30, 2008) plus 2.5% or the bank's prime rate (5.0% at September 30, 2008) plus 0.5%, at the Company's option. The facility expires at the earlier of July 2, 2012 or thirty days prior to the maturity date of the loan agreement with the private investment firm (January 18, 2009) unless it is refinanced on terms acceptable to the bank. The average borrowings under this facility during the nine months ended September 30, 2008 were \$51.8 million.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50 million for the fiscal year ending December 31, 2008. The default under the SOF Credit Agreement also resulted in a cross default under the revolving credit facility with LaSalle Bank. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the Eighth Amendment) with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74 million. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings. The Eighth Amendment also cured the cross default under the revolving credit facility.

On June 20, 2008, the Registrant, in its capacity as Facility Guarantor, American Apparel (USA), LLC, a subsidiary of the Company, in its capacity as Lead Borrower, and certain other subsidiaries of the Company, in their capacities as Borrowers or Facility Guarantors, entered into a Fourth Amendment to Credit Agreement (the Fourth Amendment) with LaSalle Business Credit, LLC, LaSalle Bank National Association, Wells Fargo Retail Finance, LLC and the lenders party to the Credit Agreement, dated as of July 2, 2007 (as previously amended, the LaSalle Credit Agreement). Capitalized terms used but not defined in this description of the Fourth Amendment have the respective meanings set forth in the LaSalle Credit Agreement.

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The Fourth Amendment amended the LaSalle Credit Agreement to, among other things: (i) delete financial covenants relating to minimum Consolidated EBITDA, maximum Capital Expenditures, Consolidated Fixed Charge Coverage Ratio, Senior Debt to Consolidated EBITDA ratio and Adjusted Debt to EBITDAR ratio; (ii) increase Minimum Excess Availability from \$3 million to 10% of the lesser of the Borrowing Base and the Revolving Credit Ceiling; (iii) increase the Permitted Indebtedness threshold for capital leases from \$15.0 million to \$20.0 million; (iv) permit the repurchase of up to \$30.0 million of the Loan Parties' capital stock if certain conditions are met; (v) provide additional flexibility for investing in foreign subsidiaries; (vi) add the Registrant as a Facility Guarantor; and (vii) increase from 2.00% to 2.50% the applicable margin for LIBOR-based borrowings and increase from zero to 0.50% the applicable margin for borrowings based on the bank's prime rate.

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(b) At September 30, 2008, the CI Companies had another line of credit with a bank that provided for borrowings up to C\$4.0 million due on demand, bearing interest at the bank's prime rate (4.75% at September 30, 2008) plus 0.75%. This line of credit is secured by a \$7.5 million moveable hypothec, which provides for a charge on the CI Companies' accounts receivable, inventory and all other moveable assets and by Section 427 security under the Bank Act of Canada on inventory. The credit agreement contains various covenants which require the CI Companies to maintain certain financial ratios and commitments as defined by the bank.

(c) On January 18, 2007, the Company completed a \$41.0 million secured debt financing from SOF Investments L.P. Private IV. The proceeds of the financing were used to repay American Apparel's subordinated notes payable held by C3 Capital Partners, L.P., of \$15.0 million (including principal, interest and fees), and to repay bank term loans of \$5.6 million. Net proceeds related to the secured debt financing amounted to approximately \$18.0 million. On July 2, 2007, the Company obtained an additional \$10.0 million secured debt financing with SOF Investments under the same terms as the original agreement dated January 18, 2007. Indebtedness under the agreement bears interest at 16% per annum, payable monthly and matures on January 18, 2009. The agreement requires the Company to meet certain financial covenants. In the event the Company is in default under the agreement, the interest rate increases to 21% per annum and the lender has the right to demand payment in full of all outstanding indebtedness. Any prepayment must include a prepayment premium equal to 3% of the amount prepaid.

On June 20, 2008, the Registrant, in its capacity as a Facility Guarantor, American Apparel (USA), LLC, in its capacity as Borrower, and certain other subsidiaries of the Company, in their capacities as Facility Guarantors, entered into Amendment No. 7 to Credit Agreement (the "Seventh Amendment") with SOF Investments, L.P. Private IV, as Lender, to amend the Credit Agreement, dated as of July 18, 2007 (as amended, the "SOF Credit Agreement"). Capitalized terms used but not defined in this description of the Seventh Amendment have the respective meanings set forth in the SOF Credit Agreement.

The Seventh Amendment amended the SOF Credit Agreement to, among other things: (i) measure financial covenants at the level of the Company instead of American Apparel (USA), LLC; (ii) delete the financial covenant relating to Consolidated Fixed Charge Coverage ratio; (iii) increase the Permitted Indebtedness threshold for capital leases from \$15.0 million to \$20.0 million; (iv) permit the repurchase of up to \$30.0 million of the Loan Parties' capital stock if certain conditions are met; (v) provide additional flexibility for investing in foreign subsidiaries; (vi) add the Registrant as a Facility Guarantor; increase the limit on Annual Capital Expenditures to \$50.0 million; and (viii) increase the level of Consolidated EBITDA required by the minimum Consolidated EBITDA covenant.

In November 2008, the Company determined that it violated a covenant in the SOF Credit Agreement that prohibited it from making capital expenditures in excess of \$50 million for the fiscal year ending December 31, 2008. On November 7, 2008, the Company, in its capacity as a facility guarantor under the SOF Credit Agreement, American Apparel (USA), LLC, in its capacity as a borrower, and certain other subsidiaries of the Company, in their capacities as facility guarantors under the SOF Credit Agreement, entered into Amendment No. 8 and Waiver to Credit Agreement (the "Eighth Amendment") with SOF Investments, L.P. Private IV, as lender, to amend the SOF Credit Agreement. The Eighth Amendment waived, as of September 30, 2008, any defaults arising out of the failure to comply with the capital expenditures covenant under the SOF Credit Agreement for the fiscal year ending December 31, 2008 and amended the capital expenditures covenant under the SOF Credit Agreement to increase the limit on the capital expenditures covenant for the fiscal year ending December 31, 2008 to \$74 million. The Company believes that such increase to the limit on capital expenditures will be sufficient to enable the Company to complete planned capital expenditures through the end of the current fiscal year, including capital expenditures expected to be incurred in the fourth quarter of 2008 for new store openings.

The Company is evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement, which currently matures on January 18, 2009. If by December 19, 2008 the Company is unable to extend or renew the SOF Credit Agreement, or refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, all outstanding obligations under the LaSalle Credit Agreement will become due on December 19, 2008.

(d) American Apparel leases certain equipment under capital lease arrangements expiring at various times through 2012. The assets and liabilities under capital leases are recorded at the lower of the present values of the minimum lease payments or the fair values of the assets.

(e) The Company has two loans from the Company's CEO, one with a principal balance of \$2.1 million and one with a principal balance of \$3.8 million. At December 31, 2007, the aggregate balance of these loans was \$6.0 million. At September 30, 2008, the aggregate balance of these loans was \$5.9 million. Both loans bear interest at 6% per annum commencing December 11, 2007, and mature in 2012. During the three months ended September 30, 2008 and 2007, the aggregate interest expense on both loans was \$0.1 million and \$0.1 million, respectively, and \$0.3 million and \$0.4 million during the nine months ended September 30, 2008 and 2007, respectively. Prior to December 12, 2007, these loans were non-interest bearing and without terms of repayment. The Company's CEO subordinated this loan in favor of the Toronto Dominion Bank on February 18, 2008. During the nine months ended September 30, 2008, \$0.4 million was paid to the CEO, of which \$0.1 million was repaid in March 2008, \$0.2 million was repaid in April 2008, and the remaining balance was repaid in May 2008.

**Financial Covenants**

American Apparel's credit arrangements impose certain restrictions on American Apparel and limit American Apparel's ability to, among other things: incur additional indebtedness, dispose of assets, make repayments of indebtedness or amendments of debt instruments, make capital expenditures, pay distributions, create liens on assets and enter into sale and leaseback transactions, investments, loans or advances and acquisitions. Such restrictions could limit American Apparel's ability to respond to market conditions, to provide for unanticipated capital investments or to take advantage of business or acquisition opportunities.

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**Table of Contents****Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors, except for the financing commitments previously discussed.

**Inflation**

Inflation affects the cost of raw materials, goods and services used by the Company. In recent years, inflation has been modest. However, high oil costs can affect the cost of all raw materials and components. The competitive environment limits the ability of the Company to recover higher costs resulting from inflation by raising prices. Although American Apparel cannot precisely determine the effects of inflation on its business, it is management's belief that the effects on revenues and operating results have not been significant. The Company seeks to mitigate the adverse effects of inflation primarily through improved productivity and strategic buying initiatives. The Company does not believe that inflation has had a material impact on its results of operations for the periods presented, except with respect to payroll-related costs and other costs arising from or related to government imposed regulations.

**Accounting Pronouncements-Newly Issued and Adopted**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157 Fair Value Measurements, ( SFAS No. 157 ) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company has implemented SFAS No. 157 and has determined that the results did not have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 ( SFAS No. 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company has implemented SFAS No. 159 and has determined that the results did not have a material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations ( SFAS No. 141R ), which replaces SFAS No. 141, Business Combinations. SFAS No. 141R establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including noncontrolling interests, contingent consideration, and certain acquired contingencies. SFAS No. 141R also requires acquisition-related transaction expenses and restructuring costs be expensed as incurred rather than capitalized as a component of the business combination. SFAS No. 141R will be applicable prospectively to business combinations for which the acquisition date is on or after January 1, 2009. SFAS No. 141R would have an impact on accounting for any businesses acquired after the effective date of this pronouncement.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51 ( SFAS No. 160 ). SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary (previously referred to as minority interests). SFAS No. 160 also requires that a retained noncontrolling interest upon the deconsolidation of a subsidiary be initially measured at its fair value. Upon effectiveness of SFAS No. 160, the Company would be required to report any noncontrolling interests as a separate component of consolidated stockholders' equity. The Company would also be required to present any net income allocable to noncontrolling interests and net income attributable to the stockholders of the Company separately in its consolidated statements of operations. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after January 1, 2009. SFAS No. 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS No. 160 shall be applied prospectively. SFAS No. 160 would have an impact on the presentation and disclosure of the noncontrolling interests of any non wholly-owned businesses acquired in the future.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Hedging Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( SFAS No. 161 ). SFAS No. 161, which is effective January 1, 2009, requires enhanced qualitative and quantitative disclosures with respect to derivatives and hedging activities. The Company does not anticipate SFAS No. 161 to have a material impact on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position SFAS 142-3, Determination of the Useful Life of Intangible Assets ( FSP SFAS 142-3 ). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life

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of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset

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under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, Business Combinations, and other U.S. GAAP principles. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP SFAS 142-3 is effective January 1, 2009, and is not expected to have a material the impact on the Company's consolidated financial statements

There are no other recently issued accounting pronouncements that are expected to have a material impact on the Company's consolidated financial statements.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company's exposure to market risk is limited to interest rate risk associated with American Apparel's credit facilities and foreign currency exchange risk associated with American Apparel's foreign operations.

*Interest Rate Risk*

Based on the Company's interest rate exposure on variable rate borrowings at September 30, 2008, a 1% increase in average interest rates on the Company's borrowings would increase future interest expense by approximately \$42 per month. The Company determined these amounts based on approximately \$50.4 million of variable rate borrowings at September 30, 2008, multiplied this amount by 1% and divided by twelve. The Company is currently not using any interest rate collars or hedges to manage or reduce interest rate risk. As a result, any increase in interest rates on the Company's variable rate borrowings would increase interest expense and reduce net income.

*Foreign Currency Risk*

The majority of American Apparel's operating activities are conducted in U.S. dollars. During the nine months ended September 30, 2008, approximately 39% of American Apparel's sales are denominated in other currencies such as Euros, British Pounds Sterling or Canadian Dollars. Nearly all of American Apparel's production costs and material costs are denominated in U.S. dollars although the majority of the yarn is sourced from outside the United States. If the U.S. dollar were to appreciate by 10% against other currencies it could have a significant adverse impact on American Apparel's earnings. Since an appreciated dollar makes goods produced in the United States relatively more expensive to overseas customers, other things being equal, the Company would have to lower its retail merchandise margin in order to maintain sales volume overseas. A lower retail margin overseas would adversely affect net income assuming sales volume remains the same.

The functional currencies of American Apparel's foreign operations consist of the Canadian dollar for the Canadian operations, the pound Sterling for the U.K. operations, the Euro for the operations in Continental Europe, the Japanese Yen for the operations in Japan, the Korean Won for the operations in South Korea, and the respective local currencies for any of the foreign operations not mentioned.

The Company enters into forward contracts to mitigate the cash and income statement impact of fluctuations in foreign currencies. At September 30, 2008, the Company's Canadian and Continental European operations held forward exchange contracts in aggregate amounts of \$1.3 million and \$2.3 million, respectively, to hedge forecasted purchases of inventory in U.S. dollars through December 31, 2008. At September 30, 2008, net gains on forward foreign exchange contracts, representing the fair value of the contracts using quoted market rates, amounted to approximately \$202 primarily related to the Euro forward contracts, and were charged to earnings and accrued expenses on the condensed consolidated balance sheet.

**Item 4. Controls and Procedures**

***(a) Disclosure Controls and Procedures***

Under the supervision and participation of the Company's management, including the Company's CEO and Chief Financial Officer, the Company conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures as such term is defined under Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act).

Based upon this evaluation and due to material weaknesses existing in our internal controls as of December 31, 2007 (described below), which have not been fully remediated as of September 30, 2008, we have concluded that as of September 30, 2008, our disclosure controls and procedures were ineffective.





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A material weakness is a deficiency, or a combination of deficiencies, in Internal Control over Financial Reporting (ICFR), such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. Material weaknesses would permit information required to be disclosed by the Company in the reports that it files or submits to not be recorded, processed, summarized and reported, within the time periods

specified in the Securities Exchange Commission's rules and forms. As of December 31, 2007, the following material weaknesses existed:

- 1) **Ineffective Entity-Level Controls:** The Company did not maintain effective entity-level controls as defined by the framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Specifically, the Company did not maintain a sufficient number of adequately trained personnel necessary to anticipate and identify risks critical to financial reporting.
- 2) **Inadequate Expertise in the application of U.S. Generally Accepted Accounting Principles:** The Company lacks adequately trained accounting personnel with appropriate United States generally accepted accounting principles (US GAAP) expertise:
  - a. Accounting for Income Taxes: The Company lacked the expertise in accounting for income taxes in relation to the provision for income taxes, including deferred taxes, in its consolidated financial statements.
  - b. Financial Reporting by Foreign Subsidiaries: The Company's accounting personnel in foreign offices lack sufficient expertise in US GAAP to identify accounting issues that could materially impact the consolidated financial statements.
  - c. Other Accounting Matters: The Company's accounting personnel lacked sufficient US GAAP expertise to ensure material non-routine transactions are properly reflected in its consolidated financial statements.
- 3) **Inadequate Reviews:** There was inadequate independent review by the Company's personnel of reconciliations and other processes in both the U.S. and foreign operations.
- 4) **Inadequate Financial Information Systems:** The Company's world-wide financial information systems were not integrated and contain many manual processes that may cause the Company to not meet regulatory filing requirements on a timely and accurate basis. The Company has also identified information technology control weaknesses in the areas of information security, end-user computing, systems program development and change controls.

**(b) Remediation Activities**

Since the merger occurred on December 12, 2007, so close to the Company's year-end, it was not practical to sufficiently upgrade the Company's ICFR to the level required of a public company. However, in the first nine months of 2008 the Company has been implementing the remediation steps outlined below to remediate the material weaknesses identified. In particular, the Company has engaged consultants and additional staff with appropriate credentials and US GAAP expertise to assist with the financial closing process and the preparation of the Company's financial statements. These remedial steps are ongoing, and the Company has performed additional analyses and other post-closing procedures to ensure the consolidated financial statements contained in this Quarterly Report were prepared in accordance with US GAAP and SEC regulations. The Company engaged a qualified firm to assist with our assessment on the effectiveness of the Company's ICFR based upon the framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. The qualified firm is assisting the Company management's assessment of the effectiveness of the Company's ICFR and in addressing internal control weakness. There can be no assurances that such remediation activities will eliminate all material weaknesses in the future. We are currently in the process of:

- 1) **Ineffective Entity-Level Controls:** The Company has added and is continuing to add additional staff with appropriate education and professional qualifications to improve its Entity Level controls. The Company has used additional staffing and selected third parties to improve disclosure and internal controls and to improve the timeliness and accuracy of its financial reporting. The Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.
- 2) **Inadequate Expertise in the application of U.S. Generally Accepted Accounting Principles:** The Company has hired additional credentialed professional staff with greater knowledge of US GAAP in both its domestic operations, and in the oversight and management of its foreign operations. In addition, the Company has engaged appropriate professional services firms in order to improve the accuracy of its financial reporting under US GAAP in the primary foreign reporting locations. The Company's management has a sufficient knowledge to review the work of internal and external subject matter experts, and reviews all workpapers from its foreign operations to ensure compliance with US

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GAAP. The Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.

3) ***Inadequate Reviews:*** Additional Company staffing, along with the use of consultants and new procedures, has substantially improved the review of reconciliations and other processes in both the U.S. and foreign operations. The Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.

4) ***Inadequate Financial Information Systems:*** The Company has identified systems and applications that impact financial reporting and is taking actions to safeguard financial reporting information assets as well as to help ensure the integrity of financial

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information used in the preparation of financial reports. The Company has adopted an Information Technology framework, is documenting key information technology controls and is addressing control weaknesses that could potentially impact financial reporting. Also, the Company is in the process of implementing an integrated ERP system for its U.S. operations. It has reviewed its personnel and information systems for foreign operations and has added professional staff resources for review and control over financial reporting by the foreign operations. The Company has placed substantial mitigating controls around its heretofore manual consolidation process, and is in the process of implementing a high-level replacement system for those manual processes to further improve controls and to reduce the time required to produce its financial statements and regulatory filings. In addition, the Company has identified and implemented additional review controls over financial reporting to validate information derived from its information systems and ultimately reported in our financial statements. As the Company continues to upgrade various systems, controls and procedures, and is continuing to make substantial progress toward remediation of its material weaknesses and significant deficiencies.

***(c) Changes in ICFR***

During the first nine months of 2008, the Company's management has initiated the steps outlined above under Remediation Activities to improve the quality of its ICFR.

**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

The Company is subject to various claims and contingencies in the ordinary course of its business, including those related to litigation, business transactions, employee-related matters and taxes, and others. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the Company will record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. Most of these matters are covered by insurance which the Company expects will be sufficient to cover all litigation costs, potential settlements or any adverse judgments, except for any applicable deductible or retention amounts. Accordingly, the Company does not expect that any of its pending legal proceedings will have any material financial impact on the Company's results.

On or about September 19, 2005, Ms. Mary Nelson, an independent contractor in the sales department at American Apparel commenced a suit in a case captioned as Mary Nelson v. American Apparel, Inc., et al., wherein she alleges she was wrongfully terminated, was subjected to harassment and discrimination based upon her gender and other claims related to her tenure at American Apparel. The Company denies all of Ms. Nelson's allegations of wrongdoing. Ms. Nelson is seeking unspecified monetary damages and costs. The trial has been stayed, and the Court of Appeal of the State of California has reversed the Superior Court's denial of the Company's motion to compel arbitration pursuant to an agreement among the parties. The Company anticipates that an arbitration will now occur. As described further in the Company's Form 10-K for the year ended December 31, 2007, the insurance carrier for the Company's directors' and officers' insurance policy has asserted that it is not obligated to provide coverage for this proceeding.

Other than as stated above, during the three months ended September 30, 2008, there have been no material changes in the Company's legal proceedings previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007 and the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2008 and June 30, 2008. Please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2007 and Quarterly Reports on Form 10-Q for the quarters ended March 31, 2008 and June 30, 2008 for information regarding current legal proceedings.

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Before deciding to invest in our Company or to maintain or increase your investment, you should carefully consider the information under Special Note Regarding Forward-Looking Statements and the risks described below as well as the other information in this report and our other filings with the SEC. The risks and uncertainties described below, in our other filings with the SEC and under Special Note Regarding Forward-Looking Statements are not the only ones facing our Company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect us. If any of these risks actually materialize, our business, financial position, results of operations and cash flows could be adversely impacted. In that event, the market price of our common stock could decline and you may lose all or part of your investment.

During the nine months ended September 30, 2008, there have been no material changes in the Company's risk factors previously disclosed in the Company's Annual Report on Form 10-K and Amendments 1 and 2 thereto for the year ended December 31, 2007 except for adding the risk factors described below. Please refer to the Company's Annual Report on Form 10-K and Amendments 1 and 2 thereto for the year ended December 31, 2007 (filed with the SEC on March 17, 2008, March 28, 2008 and April 29, 2008) for a list of the Company's risk factors.

*Significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our revenues, operating income, net income and earnings per share, as well as future cash flows.*

We face exposure to adverse movements in foreign currency exchange rates as a result of our international operations. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore potentially less competitive in foreign markets. Conversely, lowering our price in local currency may result in lower U.S.-based revenue. A decrease in the value of the U.S. dollar relative to foreign currencies could increase the cost of local operating expenses. We utilize certain foreign currency forward exchange contracts to hedge our foreign currency exposure associated with certain assets and liabilities as well as anticipated foreign currency cash flows. These hedges are designed to reduce, but do not always entirely eliminate, the impact of currency exchange movements. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets as well as widening interest rate differentials and the volatility of the foreign exchange market. There can be no assurance that such hedging strategies will be successful and that currency exchange rate fluctuations will not have a material adverse effect on our operating results. In addition, while the hedges are designed to reduce volatility over the forward contract period, the contracts are not treated as hedges for accounting purposes, and therefore can create volatility in earnings during the period. The degree to which the Company's financial results are affected for any given period will depend in part upon the Company's hedging activities. See also Notes to the Company's Condensed Consolidated Financial Statements.

*Our existing credit facilities mature in December 2008 and January 2009, and, as a result, our liquidity will be materially adversely affected unless we are able to refinance or renew our credit facilities, or obtain replacement financing, on acceptable terms.*

The indebtedness under the SOF Credit Agreement matures on January 18, 2009, and the indebtedness under the LaSalle Credit Agreement matures on the earlier of (x) July 2, 2012 and (y) the date which is thirty days prior to the maturity of the SOF Credit Agreement. Therefore, unless the SOF Credit Agreement is extended or renewed, or the SOF Credit Agreement is refinanced on terms acceptable to the lenders under the LaSalle Credit Agreement, the indebtedness under the SOF Credit Agreement will mature on December 19, 2008. As of September 30, 2008, we had approximately \$100 million of outstanding borrowings under these credit agreements. We are evaluating various alternatives to extend, renew or refinance the SOF Credit Agreement. Due to the recent global financial and credit crisis, credit standards have tightened and the cost to borrowers to refinance indebtedness, or extend existing indebtedness, has significantly increased. At the present time, we cannot determine the duration of the current financial crisis or whether or not the situation may intensify. Accordingly, there is no assurance that we will be able to extend, renew or refinance any or all of our outstanding indebtedness, or if an extension, renewal or refinancing is available, that it can be obtained on terms that we can afford. The amount of our indebtedness could have important consequences for us, including the following: require us to dedicate a substantial portion of our cash flow from operations to make payments on our debt, thereby reducing funds available for operations, investments and future business opportunities and other purposes; limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; reduce our ability to make acquisitions or expand our business; make it more difficult for us to satisfy our debt obligations, and any failure to comply with such obligations, including financial and other restrictive covenants, could result in an event of default under the agreements governing such indebtedness, which could lead to, among other things, an acceleration of our indebtedness or foreclosure on the assets securing our indebtedness, which could have a material adverse effect on our business or financial condition; limit our ability to borrow additional funds, or to sell assets to raise funds, if needed, for working capital, capital expenditures, acquisitions or other purposes; and increase our vulnerability to general adverse economic and industry conditions, including changes in interest rates. If by December 19, 2008 we fail to extend or renew the SOF Credit Agreement, or to refinance the SOF Credit Agreement on terms acceptable to the lenders under the LaSalle Credit Agreement, our outstanding borrowings under the SOF Credit Agreement would become due on January 18, 2009, resulting in our outstanding borrowings under the LaSalle Credit Agreement becoming due on December 19, 2008. In such event, we may not generate sufficient cash flow from operations to service and repay our debt and related obligations and still have sufficient

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funds left over to achieve or sustain profitability in our operations, meet our working capital and capital expenditure needs or compete successfully in our industry. Furthermore, since our credit facilities are secured by substantially all of our assets, in the event that we are unable to repay our debt under these agreements, substantially all of our assets would be subject to foreclosure by our creditors. Failure to complete the necessary repayments, refinancings or extensions of our credit agreements would have a material adverse effect on us.

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**Table of Contents*****Disruptions in the global financial markets could adversely impact our liquidity and our ability to obtain financing, including by affecting the ability of our counterparties and others to perform their obligations to us.***

Our liquidity may be negatively impacted if one of our lenders under our credit agreements or other debt agreements, or another financial institution, suffers liquidity issues. In such an event, we may not be able to draw on all, or a substantial portion, of our debt agreements. The current economic environment could cause our lenders, counterparties and others to breach their obligations to us under our contracts with them, which could include failures of banks or other financial service companies to fund required borrowings under our debt agreements, to pay us amounts that may become due under our derivative contracts for interest rates and foreign currencies, and to pay us amounts that may become due under other agreements or our counterparties might limit or place burdensome conditions upon future transactions with the Company. Any of the foregoing could adversely impact our business, financial condition and results of operations.

Also, if we attempt to obtain future financing, the credit market turmoil could negatively impact our ability to obtain such financing. In the event we need access to additional capital to pay our operating expenses, make payments on our indebtedness or pay capital expenditures, our ability to obtain such capital may be limited and the cost of any such capital may be significant. Our access to additional financing will depend on a variety of factors such as market conditions, the general availability of credit, the overall availability of credit to our industry, our credit ratings and credit capacity, as well as the possibility that lenders could develop a negative perception of our long-term or short-term financial prospects. If a combination of these factors were to occur, our internal sources of liquidity may prove to be insufficient, and in such case, we may not be able to successfully obtain additional financing on favorable terms or at all. In addition, the credit market turmoil could negatively impact certain of our customers and suppliers which could lead to a decrease in demand for our products and could have a material adverse impact on the Company's financial condition and operating results.

Further, market conditions have resulted in severe downward pressure on the stock and credit markets, which could reduce the return available on invested corporate cash and thereby potentially increase funding obligations, which, if severe and sustained, could have material and adverse impacts on the Company's results of operations and cash flows.

***Economic conditions may cause a decline in consumer spending which could adversely affect our business and financial performance.***

The Company's operations and performance depend significantly on worldwide economic conditions and their impact on levels of consumer spending, particularly in discretionary areas, such as apparel, which have recently deteriorated significantly in the United States and many other countries and regions and may remain depressed for the foreseeable future. Our business and financial performance, including our sales and the collection of our accounts receivable, may be adversely affected by the current decrease and any future decrease in economic activity in the United States or in other regions of the world in which we do business that cause a decline in consumer spending, including a reduction in the availability of credit, increased unemployment levels, higher fuel and energy costs, rising interest rates, adverse conditions in the housing markets, financial market volatility, recession, decreased access to credit, reduced consumer confidence, acts of terrorism and other macroeconomic factors affecting consumer spending behavior. A decrease in consumer discretionary spending as a result of the current economic conditions may decrease the demand for our products. If consumer spending continues to slow down or decrease, we will not be able to improve our same store sales. In addition, reduced consumer spending may cause us to lower prices, suffer significant product returns from our customers or drive us to offer additional products at promotional prices, any of which would have a negative impact on gross profit.

Our ability to meet customers' demands depends, in part, on our ability to obtain timely and adequate delivery of materials, parts and components from our suppliers. The current global financial crisis may materially adversely affect the ability of our suppliers to obtain financing for significant purchases and operations. If certain key suppliers were to become capacity constrained or insolvent as a result of the financial crisis, it could result in a reduction or interruption in supplies or a significant increase in the price of supplies and adversely impact consumer spending and our financial results. Reduced revenues as a result of decreased consumer spending may also reduce our working capital for planned store improvements and to open additional stores in the manner that we have in the past. These and other economic factors could have a material adverse effect on demand for the American Apparel's products and on our financial condition and operating results. In addition, as a result of decreased revenues and working capital, we may be required to seek additional financing which may not be available on acceptable terms or at all. There can be no assurances that government responses to the disruptions in the financial markets will restore consumer confidence, stabilize such markets or increase liquidity and the availability of credit to consumers and businesses. We are not able to predict the duration and severity of the current disruption in the financial markets and adverse economic conditions in the United States and other countries. As a consequence, American Apparels' operating results for a particular period are difficult to predict, and, therefore, prior results are not necessarily indicative of results to be expected in future periods. Any of the foregoing effects could have a material adverse effect on our business, results of operations, and financial condition and could adversely affect our stock price.

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**Item 6. Exhibits**

- 3.1 Amended and Restated Certificate of Incorporation of the Registrant (included as Exhibit 3.1 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)
- 3.2 Bylaws of the Registrant (included as Exhibit 3.1 of the Current Report on Form 8-K (File No. 001-32697) filed November 9, 2007 and incorporated by reference herein)
- 31.1\* Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer
- 31.2\* Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer
- 32.1\* Section 1350 Certification of the Principal Executive Officer
- 32.2\* Section 1350 Certification of the Principal Financial Officer

\* Filed herewith



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**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.

Date: November 10, 2008

AMERICAN APPAREL, INC.

By: */s/ DOV CHARNEY*  
**Dov Charney**  
**President and Chief Executive Officer**  
**(Principal Executive Officer)**

Date: November 10, 2008

AMERICAN APPAREL, INC

By: */s/ WILLIAM T. GOCHNAUER*  
**William T. Gochnauer**  
**Chief Financial Officer**  
**(Principal Financial Officer)**