TAG IT PACIFIC INC
Form 10-Q
August 22, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 June 30, 2005.

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from ____________ to _______________.

Commission file number 1-13669

TAG-IT PACIFIC, INC.
(Exact Name of Issuer as Specified in its Charter)

DELAWARE	95-4654481
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

21900 BURBANK BOULEVARD, SUITE 270
WOODLAND HILLS, CALIFORNIA 91367
(Address of Principal Executive Offices)

(818) 444-4100
(Registrant's Telephone Number, Including Area Code)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $0.001 per share, 18,241,045 shares issued and outstanding as of August 22, 2005.

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CAUTIONARY LEGEND REGARDING FORWARD-LOOKING STATEMENTS

Some of the information in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, both as amended. These forward-looking statements are subject to various risks and uncertainties. The forward-looking statements include, without limitation, statements regarding our future business plans and strategies and our future financial position or results of operations, as well as other statements that are not historical. You can find many of these statements by looking for words like "will", "may", "believes", "expects", "anticipates", "plans" and "estimates" and for similar expressions. Because forward-looking statements involve risks and uncertainties, there are many factors that could cause the actual results to differ materially from those expressed or implied. These include, but are not limited to, economic conditions. This Quarterly Report on Form 10-Q contains important cautionary statements and a discussion of many of the factors that could materially affect the accuracy of Tag-It Pacific's forward-looking statements and such statements and discussions are incorporated herein by reference. Any subsequent written or oral forward-looking statements

made by us or any person acting on our behalf are qualified in their entirety by the cautionary statements and factors contained or referred to in this section. We do not intend or undertake any obligation to update any forward-looking statements to reflect events or circumstances after the date of this document or the date on which any subsequent forward-looking statement is made or to reflect the occurrence of unanticipated events.

PART I
FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS.

TAG-IT PACIFIC, INC.
CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2005	December 31, 2004
Assets		
Current Assets:		
Cash and cash equivalents	$ 2,962,082	$ 5,460,662
Trade accounts receivable, net	13,352,574	17,890,044
Trade accounts receivable, related party	3,375,000	4,500,000
Inventories, net	11,948,779	9,305,819
Prepaid expenses and other current assets	2,064,950	2,326,245
Deferred income taxes	--	1,000,000
Total current assets	33,703,385	40,482,770
Property, plant & equipment, net of accumulated depreciation and amortization	9,988,844	9,380,026
Tradename	4,110,751	4,110,750
Goodwill	450,000	450,000
License rights	198,625	259,875
Due from related parties	578,406	556,550
Other assets	1,012,947	1,207,885
Total assets	$ 50,042,958	$ 56,447,856
Liabilities and Stockholders' Equity		
Current Liabilities:		
Line of credit	$ 1,001,309	$ 614,506
Accounts payable and accrued expenses	14,780,039	7,460,916
Demand notes payable to related parties	664,971	664,971
Current portion of capital lease obligations	844,231	859,799
Current portion of notes payable	180,809	174,975
Note payable	200,000	1,400,000
Total current liabilities	17,671,359	11,175,167
Capital lease obligations, less current portion	1,049,982	1,220,969
Notes payable, less current portion	1,355,969	1,447,855
Secured convertible promissory notes	12,424,491	12,408,623

Total liabilities	32,501,801	26,252,614
Guarantees and Contingencies (Note 4)		
Stockholders' equity:		
Preferred stock, Series A $0.001 par value; 250,000 shares authorized, no shares issued or outstanding	--	--
Common stock, $0.001 par value, 30,000,000 shares authorized; 18,241,045 shares issued and outstanding at June 30, 2005; 18,171,301 at December 31, 2004	18,243	18,173
Additional paid-in capital	51,327,873	51,073,402
Accumulated deficit	(33,804,959)	(20,896,333)
Total stockholders' equity	17,541,157	30,195,242
Total liabilities and stockholders' equity	$ 50,042,958	$ 56,447,856

See accompanying notes to consolidated financial statements.

TAG-IT PACIFIC, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30,		Six Month
	2005	2004	2005
Net sales	$ 18,473,236	$ 14,923,121	$ 31,528,5
Cost of goods sold	16,500,664	11,030,867	26,304,1
Gross profit	1,972,572	3,892,254	5,224,3
Selling expenses	655,295	702,482	1,397,6
General and administrative expenses	11,008,446	2,791,209	14,735,7
Total operating expenses	11,663,741	3,493,691	16,133,3
(Loss) income from operations	(9,691,169)	398,563	(10,908,9
Interest expense, net	268,021	144,355	536,6
(Loss) income before income taxes	(9,959,190)	254,208	(11,445,6
Provision (benefit) for income taxes	1,300,996	83,889	1,463,0
Net (loss) income	$(11,260,186)	$ 170,319	$(12,908,6
Less: Preferred stock dividends	--	--	--
Net (loss) income to common shareholders	$(11,260,186)	$ 170,319	$(12,908,6

Basic (loss) earnings per share	$ (0.62)	$ 0.01	$ (0.
Diluted (loss) earnings per share	$ (0.62)	$ 0.01	$ (0.
Weighted average number of common shares outstanding:			
Basic	18,241,045	18,061,778	18,210,4
Diluted	18,241,045	18,779,239	18,210,4

See accompanying notes to consolidated financial statements.

TAG-IT PACIFIC, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six months Ended June 30,	
	2005	2004
Increase (decrease) in cash and cash equivalents		
Cash flows from operating activities:		
Net loss	$(12,908,629)	$ (381,710)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	1,127,169	730,153
Increase in allowance for doubtful accounts	6,120,691	147,282
Increase in deferred tax asset valuation allowance	1,000,000	--
Increase in inventory valuation reserve	1,550,000	--
Common stock issued for services	--	74,825
Changes in operating assets and liabilities:		
Receivables, including related parties	(458,222)	(6,777,637)
Inventories	(4,192,959)	(1,907,176)
Other assets	(4,445)	(236,854)
Prepaid expenses and other current assets	321,295	929,415
Accounts payable and accrued expenses	7,182,615	739,019
Income taxes payable	114,651	(434,901)
Net cash used in operating activities	(147,834)	(7,117,584)
Cash flows from investing activities:		
Acquisition of property and equipment	(1,248,886)	(337,082)
Cash flows from financing activities:		
Proceeds (repayment) of bank line of credit, net	386,803	(1,160,152)
Proceeds from exercise of stock options and warrants	254,541	424,801
Repayment of capital leases	(457,152)	(299,377)
Repayment of notes payable	(1,286,052)	(600,000)
Net cash used in financing activities	(1,101,860)	(1,634,728)

Net decrease in cash	(2,498,580)	(9,089,394)
Cash at beginning of period	5,460,662	14,442,769
Cash at end of period	$ 2,962,082	$ 5,353,375
Supplemental disclosures of cash flow information:		
Cash received (paid) during the period for:		
Interest paid	$ (655,032)	$ (324,292)
Income taxes paid	$ (47,560)	$ (255,067)
Income taxes received	$ 29,734	$ --
Non-cash financing activities:		
Preferred Series D stock converted to common stock	$ --	$ 22,918,693
Preferred Series C stock converted to common stock	$ --	$ 2,895,001
Accrued dividends converted to common stock	$ --	$ 458,707
Capital lease obligation	$ 270,597	$ 249,418

See accompanying notes to consolidated financial statements.

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TAG-IT PACIFIC, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. PRESENTATION OF INTERIM INFORMATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and in accordance 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 accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited consolidated financial statements reflect all adjustments that, in the opinion of the management of Tag-It Pacific, Inc. and Subsidiaries (collectively, the "Company"), are considered necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. The results of operations for such periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in the Company's Form 10-K for the year ended December 31, 2004. The balance sheet as of December 31, 2004 has been derived from the audited financial statements as of that date but omits certain information and footnotes required for complete financial statements.

2. EARNINGS PER SHARE

The following is a reconciliation of the numerators and denominators of the basic and diluted (loss) earnings per share computations:

THREE MONTHS ENDED JUNE 30, 2005:	(LOSS) INCOME	SHARES	PER SHARE

Basic loss per share:			
Loss available to common stockholders .	$(11,260,186)	18,241,045	$ (0.62)
Effect of Dilutive Securities:			
Options	--	--	--
Warrants	--	--	--
Loss available to common stockholders .	$(11,260,186)	18,241,045	$ (0.62)
THREE MONTHS ENDED JUNE 30, 2004:			
Basic earnings per share:			
Income available to common stockholders	$ 170,319	18,061,778	$ 0.01
Effect of Dilutive Securities:			
Options	--	584,415	--
Warrants	--	133,046	--
Income available to common stockholders	$ 170,319	18,779,239	$ 0.01

SIX MONTHS ENDED JUNE 30, 2005:	(LOSS) INCOME	SHARES	PER SHARE
Basic loss per share:			
Loss available to common stockholders	$(12,908,629)	18,210,406	$ (0.71)
Effect of Dilutive Securities:			
Options	--	--	--
Warrants	--	--	--
Loss available to common stockholders	$(12,908,629)	18,210,406	$ (0.71)
SIX MONTHS ENDED JUNE 30, 2004:			
Basic loss per share:			
Loss available to common stockholders	$ (412,215)	16,491,684	$ (0.02)
Effect of Dilutive Securities:			
Options	--	--	--
Warrants	--	--	--
Loss available to common stockholders	$ (412,215)	16,491,684	$ (0.02)

Warrants to purchase 1,510,479 shares of common stock at between $3.50 and $5.06, options to purchase 1,942,000 shares of common stock at between $1.30 and $5.23, convertible debt of $500,000 convertible at $4.50 per share and convertible debt of $12.5 million convertible at $3.65 per share were outstanding for the three and six months ended June 30, 2005, but were not included in the computation of diluted earnings per share because exercise or

conversion would have an antidilutive effect on earnings per share.

Convertible debt of $500,000, convertible at $4.50 per common share, was outstanding for the three months ended June 30, 2004, but was not included in the computation of diluted earnings per share because the effect of conversion would have an antidilutive effect on earnings per share.

Warrants to purchase 426,666 shares of common stock at between $4.57 and $5.06, options to purchase 105,000 shares of common stock at $4.63, convertible debt of $500,000 convertible at $4.50 per share and 759,494 shares of preferred Series C stock convertible at $4.94 per share were outstanding for the three months ended June 30, 2004, but were not included in the computation of diluted earnings per share because exercise or conversion would have an antidilutive effect on earnings per share.

3. STOCK BASED COMPENSATION

All stock options issued to employees had an exercise price not less than the fair market value of the Company's Common Stock on the date of grant, and in accounting for such options utilizing the intrinsic value method there is no related compensation expense recorded in the Company's financial statements for the three and six months ended June 30, 2005 and 2004. If compensation cost for stock-based compensation had been determined based on the fair market value of the stock options on their dates of grant in accordance with SFAS 123, the Company's net income (loss) and earnings (loss) per share for the three and six months ended June 30, 2005 and 2004 would have amounted to the pro forma amounts presented below:

	Three Months Ended June 30,		Six M Ended
	2005	2004	2005
Net (loss) income, as reported	$ (11,260,186)	$ 170,319	$ (12,908
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	--	--	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(65,332)	(5,224)	(77
Pro forma net (loss) income	$ (11,325,518)	$ 165,095	$ (12,985
Earnings per share:			
Basic - as reported	$ (0.62)	$ 0.01	$ (
Basic - pro forma	$ (0.62)	$ 0.01	$ (
Diluted - as reported	$ (0.62)	$ 0.01	$ (

Diluted - pro forma	$ (0.62)	$ 0.01	$ (

4. GUARANTEES AND CONTINGENCIES

In November 2002, the FASB issued FIN No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others - and interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34." The following is a summary of the Company's agreements that it has determined are within the scope of FIN 45:

In accordance with the bylaws of the Company, officers and directors are indemnified for certain events or occurrences arising as a result of the officer or director's serving in such capacity. The term of the indemnification period is for the lifetime of the officer or director. The maximum potential amount of future payments the Company could be required to make under the indemnification provisions of its bylaws is unlimited. However, the Company has a director and officer liability insurance policy that reduces its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of the indemnification provisions of its bylaws is minimal and therefore, the Company has not recorded any related liabilities.

The Company enters into indemnification provisions under its agreements with investors and its agreements with other parties in the normal course of business, typically with suppliers, customers and landlords. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by the Company with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has not recorded any related liabilities.

The Company has filed suit against Pro-Fit Holdings Limited in the U.S. District Court for the Central District of California -- TAG-IT PACIFIC, INC. V. PRO-FIT HOLDINGS LIMITED, CV 04-2694 LGB (RCx) - based on various contractual and tort claims relating to the Company's exclusive license and intellectual property agreement, seeking declaratory relief, injunctive relief and damages. The agreement with Pro-Fit gives the Company exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. Pro-Fit filed an answer denying the material allegations of the complaint and filed a counterclaim alleging various contractual and tort claims seeking injunctive relief and damages. The Company filed a reply denying the material allegations of Pro-Fit's pleading. Pro-Fit has since purported to terminate the exclusive license and intellectual property agreement based on the same alleged breaches of the agreement that are the subject of the parties' existing litigation, as well as on an additional basis unsupported by fact. In February 2005, the Company amended its pleadings in the litigation to assert additional breaches by Pro-Fit of its obligations to the Company under the agreement and under certain additional letter agreements, and for a declaratory judgment that Pro-Fit's

patent No. 5,987,721 is invalid and not infringed by the Company. Thereafter, Pro-Fit filed an amended answer and counterclaim denying the material allegations of the amended complaint and alleging various contractual and tort claims seeking injunctive relief and damages. Pro-Fit further asserted that the Company infringed its United States Patent Nos. 5,987,721 and 6,566,285. The Company filed a reply denying the substantive allegations of the reply. At the Company's request, the Court bifurcated the contract issues for trial to commence on January 10, 2006. The remaining issues will be tried at a later date. Fact discovery has been completed and expert discovery is ongoing. As we derive a significant amount of revenue from the sale of products incorporating the stretch waistband technology, our business, results of operations and financial condition could be materially adversely affected if our dispute with Pro-Fit is not resolved in a

manner favorable to us. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

The Company is subject to certain other legal proceedings and claims arising in connection with its business. In the opinion of management, there are currently no claims that will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

5. NEW ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued Statement of Financial Accounting Standard ("SFAS") No. 123R "Share Based Payment." This statement is a revision of SFAS Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. This statement is effective as of the beginning of the first annual reporting period that begins after June 15, 2005. The Company has evaluated the effects of the adoption of this pronouncement and has determined it will not have a material impact on the Company's financial statements.

In March, 2005, the Securities and Exchange Commission's ("SEC") Office of the Chief Accountant and its Division of Corporation Finance released Financial Accounting Bulletin No. 107, "Share-Based Payment" (SAB 107). SAB 107 provides interpretive guidance related to the interaction between Statement of Financial Accounting Standard No. 123R "Shared Based Payment" (SFAS 123R) and certain SEC rules and regulations. SAB 107 provides the staff's views regarding the valuation of shared-based payment arrangements for public companies and stresses the importance of including appropriate disclosures within SEC filings, particularly during the transition to SFAS 123R.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" ("APB 20") and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new

accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements for voluntary changes in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The impact of SFAS 154 will depend on the accounting change, if any, in a future period.

6. SUBSEQUENT EVENT - RESTRUCTURING

In August 2005 the Company's Board of Directors adopted a restructuring plan. The plan includes restructuring the Company's global operations by eliminating redundancies in its Hong Kong operation, reducing the functions performed at its Mexico facilities, converting its Guatemala facility from a manufacturing site to a distributor, and closing its North Carolina manufacturing facility. The Company also intends to focus its sales efforts on higher margin products, which may result in lower net sales over the next twelve months. Upon completion of this restructuring, the Company will operate with fewer employees and significantly reduce associated operating and manufacturing expenses. As a result

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of the restructuring, the Company expects to record a restructuring charge during the third quarter of 2005 of between $4 and $5 million. This plan is expected to be completed in December 2005.

7. SIGNIFICANT ADJUSTMENTS

The Company evaluated its accounts receivable, inventory, accounts payable, certain other assets and its net deferred tax asset and recorded the following significant adjustments during the three months ended June 30, 2005:

- Increased allowance for doubtful accounts by $6,381,000 based upon management's estimate of the collectibility of accounts receivable related to two customers;

- Increased inventory obsolescence reserve by $1,550,000 based upon management's estimate of the net realizable value of certain inventories;

- Recorded additional reserves of $1,523,000 to primarily reflect an increase in legal accruals, charges related to the Company's Pro-Fit litigation and a reduction in certain assets; and

- Reduced the carrying value of the Company's net deferred tax asset to zero from $1,000,000 at December 31, 2004.

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

The following discussion and analysis should be read together with the Consolidated Financial Statements of Tag-It Pacific, Inc. and the notes to the Consolidated Financial Statements included elsewhere in this Form 10-Q.

This discussion summarizes the significant factors affecting the consolidated operating results, financial condition and liquidity and cash flows of Tag-It Pacific, Inc. for the three months and six months ended June 30, 2005 and 2004. Except for historical information, the matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations are forward looking statements that involve risks and uncertainties and are based upon judgments concerning various factors that are beyond our control.

OVERVIEW

Tag-It Pacific, Inc. is an apparel company that specializes in the distribution of trim items to manufacturers of fashion apparel, specialty retailers and mass merchandisers. We act as a full service outsourced trim management department for manufacturers, a specified supplier of trim items to owners of specific brands, brand licensees and retailers, a manufacturer and distributor of zippers under our TALON brand name and a distributor of stretch waistbands that utilize licensed patented technology under our TEKFIT brand name.

We have developed, and are now implementing, what we refer to as our TALON franchise strategy, whereby we appoint suitable distributors in various geographic international regions to finish and sell zippers under the TALON brand name. Our designated franchisees purchase and install locally equipment for dying and producing finished zippers, thus minimizing our capital outlay. The franchisee will then purchase from us large zipper rolls with other materials such as sliders and produce finished zippers locally, according to their customers' specifications, in markets around the world, becoming in essence a local marketer and distributor of the TALON brand. This strategy is expected to expand the geographic footprint of our TALON division.

We have received purchase orders from two franchisees and minimum royalty payments from three franchisees. We continue to work with our existing franchisees to help them develop and grow their businesses. In keeping with this strategy of maintaining a strong, committed franchise base, we recently terminated one franchisee who was not meeting the terms of the franchise agreement. We are continuing our efforts to sign agreements with new franchisees and expand our global coverage.

We currently have five TALON franchisees located in the following regions:

Region	Agreement Date *	Term
South East Asia	March 1, 2005	42 Months
Asia	March 1 , 2005	42 Months
South East Asia	July 1, 2005	42 Months
Middle East and Africa	June 30, 2005	42 Months
Central Asia	March 31, 2005	39 Months

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* Certain dates previously reported have changed to reflect revised agreements.

As described more fully elsewhere in this report, we remain in litigation with Pro-Fit Holdings Limited relating to our exclusively licensed rights to sell or sublicense stretch waistbands manufactured

under Pro-Fit's patented technology. We supply Levi with waistbands in reliance on our agreement with Pro-Fit. As we derive a significant amount of revenue from the sale of products incorporating the stretch waistband technology, our business, results of operations and financial condition could be materially adversely affected if our dispute with Pro-Fit is not resolved in a manner favorable to us. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

RESTRUCTURING

In an effort to better align our organizational and cost structures with our future growth opportunities, in August 2005 our Board of Directors adopted a restructuring plan for our company that we expect will be completed in December 2005. The plan includes restructuring our global operations by eliminating redundancies in our Hong Kong operation, reducing the functions performed at our Mexico facilities, converting our Guatemala facility from a manufacturing site to a distributor, and closing our North Carolina manufacturing facility. Upon completion of this restructuring, we will operate with fewer employees and significantly reduce associated operating and manufacturing expenses. As a result of the restructuring, we expect to record a restructuring charge during the third quarter of 2005 of between $4 and $5 million.

As a result of the restructuring, we expect to reduce our current operating costs by approximately 25% to 30%, or $5 to $6 million, on an annualized basis. We also intend to focus our sales efforts on higher margin products, which may result in lower net sales over the next twelve months. However, by focusing on higher margin products and eliminating overhead costs from costs of goods sold, we believe our overall profits margins will improve. Higher gross profit, combined with a decrease in general and administrative costs, should improve our operating results and cash flows. The restructuring also is expected to reduce the amount of capital invested in facilities and equipment, which will reduce our capital requirements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our valuation of inventory and our allowance for uncollectable accounts receivable. We base our 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. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

o Inventory is evaluated on a continual basis and reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Reserve adjustments are made for the difference between the cost of

the inventory and the estimated market value, if lower, and charged to operations in the period in which the facts that give rise to the adjustments become known. A portion of our total inventories is subject to buyback arrangements with our customers. The buyback arrangements

contain provisions related to the inventory we purchase and warehouse on behalf of our customers, and require that these customers purchase the inventories from us in accordance with the applicable buyback arrangements. If the financial condition of a customer were to deteriorate, resulting in an impairment of its ability to purchase inventories, an additional adjustment may be required. These buyback arrangements are considered in management's estimate of future market value of inventories. See further discussion below of reserve for inventory obsolescence recorded in the second quarter of 2005.

- Accounts receivable balances are evaluated on a continual basis and allowances are provided for potentially uncollectible accounts based on management's estimate of the collectibility of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of its ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known. See further discussion below of allowance for doubtful accounts recorded in the second quarter of 2005.

- We record valuation allowances to reduce our deferred tax assets to an amount that we believe is more likely than not to be realized. We consider estimated future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. If we determine that we may not realize all or part of our deferred tax assets in the future, we will make an adjustment to the carrying value of the deferred tax asset, which would be reflected as an income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance, which would be reflected as an income tax benefit. As discussed below, during the second quarter of 2005 we reduced the carrying value of our net deferred tax asset by an additional $1,000,000, reducing the asset to zero at June 30, 2005.

- Intangible assets are evaluated on a continual basis and impairment adjustments are made based on management's valuation of identified reporting units related to goodwill, the valuation of intangible assets with indefinite lives and the reassessment of the useful lives related to other intangible assets with definite useful lives. Impairment adjustments are made for the difference between the carrying value of the intangible asset and the estimated valuation and charged to operations in the period in which the facts that

give rise to the adjustments become known.

- Sales are recorded at the time of shipment, at which point title transfers to the customer, and when collection is reasonably assured.

SIGNIFICANT SECOND QUARTER ADJUSTMENTS

During the second quarter of 2005, we evaluated our accounts receivable, inventory, certain other assets and our net deferred tax asset and recorded the following significant adjustments, resulting in a total charge against earnings of $9,454,000 and an increase in our provision for income taxes of $1,000,000.

ALLOWANCE FOR DOUBTFUL ACCOUNTS. Our allowance for doubtful accounts as of June 30, 2005 includes a reserve of $6,381,000 recorded in the second quarter of 2005 based upon management's

estimate of the collectibility of accounts receivable related to two customers. This increase in the reserve increased our general and administrative expenses by $6,381,000.

RESERVE FOR INVENTORY OBSOLESCENCE. In the second quarter of 2005, we recorded an additional reserve for inventory obsolescence totaling $1,550,000 based upon management's estimate of the net realizable value of certain inventories. This increase in the reserve increased our cost of goods sold by $1,550,000.

MISCELLANEOUS ADJUSTMENTS. In the second quarter of 2005, we recorded additional reserves of $1,523,000 to primarily reflect an increase in our legal accruals, charges related to our Pro-Fit litigation and a reduction in certain assets. These charges are reflected in cost of goods sold and general and administrative expenses.

NET DEFERRED TAX ASSET. During the first six months of 2005, we incurred additional net operating losses and therefore increased our valuation allowance to $9,900,000 from $8,900,000 which reduced the carrying value of our net deferred tax asset to zero from $1,000,000 at December 31, 2004. The increase in the valuation allowance resulted in a charge of $1,000,000 against the provision for income taxes in the second quarter of 2005.

BALANCE SHEET ADJUSTMENT. During 2004, we segregated inventory in anticipation of returning it to a vendor for modification. This resulted in a reduction in inventory and accounts payable of approximately $2,655,000. In the second quarter of 2005, since the vendor was unable to process this inventory in a timely manner, we reversed this transaction resulting in an increase in inventory and accounts payable. The inventory was recorded at its estimated realizable value requiring additional reserves of $1,200,000 which are included in RESERVE FOR INVENTORY OBSOLESCENCE above.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, selected statements of operations data shown as a percentage of net sales:

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2005	2004	2005	2004
Net sales	100.0 %	100.0 %	100.0 %	100.0
Cost of goods sold	89.3	73.9	83.4	72.6
Gross profit	10.7	26.1	16.6	27.4
Selling expenses	3.5	4.7	4.4	5.9
General and administrative expenses	59.7	18.7	46.8	22.5
Operating (loss) income	(52.5)%	2.7 %	(34.6)%	(1.0

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The following table sets forth, for the periods indicated revenues as a percentage of total sales attributed to geographical regions based on the location of the customer:

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2005	2004	2005	2004
United States	13.7 %	7.7 %	9.9 %	8.2
Asia	32.7	24.3	32.8	24.1
Mexico	39.4	39.1	37.7	37.1
Dominican Republic	9.1	19.7	12.4	19.7
Central and South America	4.1	8.7	6.2	10.5
Other	1.0	0.5	1.0	0.4
	100.0 %	100.0 %	100.0 %	100.0

Net sales increased approximately $3,550,000, or 23.8%, to $18,473,000 for the three months ended June 30, 2005 from $14,923,000 for the three months ended June 30, 2004. The increase in net sales for the three months ended June 30, 2005 was due primarily to an increase in sales from our TRIMNET programs related to major U.S. retailers and an increase in zipper sales under our TALON brand name in Asia.

Net sales increased approximately $6,446,000, or 25.7%, to $31,529,000 for the six months ended June 30, 2005 from $25,083,000 for the six months ended June 30, 2004. The increase in net sales for the six months ended June 30, 2005 was due primarily to an increase in sales from our TRIMNET programs related to major U.S. retailers and an increase in zipper sales under our TALON brand name in Asia. During the fourth quarter of 2003, we implemented a plan to restructure certain business operations, including the reduction of our reliance on two significant customers in Mexico and reported a decrease in net sales of approximately $10.0 million for the six month period ended June 30, 2004 as compared to the six month period ended June 30, 2003. We have been able to

replace substantially all of the lost revenue from our Tlaxcala, Mexico facility with new customers primarily in Mexico and Asia.

Gross profit decreased approximately $1,920,000, or 49.3% to $1,972,000 for the three months ended June 30, 2005 from $3,892,000 for the three months ended June 30, 2004. Gross profit as a percentage of net sales decreased to approximately 10.7% for the three months ended June 30, 2005 as compared to 26.1% for the three months ended June 30, 2004. The decrease in gross profit as a percentage of net sales for the three months ended June 30, 2005 was due to an increase in our inventory obsolescence reserve of $1,550,000, additional charges associated with unrealized charge backs to vendors and customers and unabsorbed overhead costs incurred in our new TALON manufacturing facility in North Carolina.

Gross profit decreased approximately $1,660,000, or 24.1% to $5,224,000 for the six months ended June 30, 2005 from $6,884,000 for the six months ended June 30, 2004. Gross profit as a percentage of net sales decreased to approximately 16.6% for the six months ended June 30, 2005 as compared to 27.4% for the six months ended June 30, 2004. The decrease in gross profit as a percentage of net sales for the six months ended June 30, 2005 was due primarily to the various charges discussed above. Also, gross profit was adversely affected by credits we issued to a customer during the first quarter of 2005 for defective products received from Pro-Fit Holdings.

Selling expenses decreased approximately $47,000 as a result of cost containment efforts to $655,000 for the three months ended June 30, 2005 from $702,000 for the three months ended June 30,

2004. Selling expense as a percentage of net sales decreased to 3.5% for the three months ended June 30, 2005 as compared to 4.7% for the three months ended June 30, 2004. For the six month period ended June 30, 2005, selling expenses decreased approximately $77,000 to $1,398,000 from $1,475,000 for the six months ended June 30, 2004 since employee costs increased at a slower rate than sales. Selling expense as a percentage of net sales decreased to 4.4% for the six months ended June 30, 2005 as compared to 5.9% for the six months ended June 30, 2004.

General and administrative expenses increased approximately $8,217,000 to $11,008,000 for the three months ended June 30, 2005 from $2,791,000 for the three months ended June 30, 2004. The increase in general and administrative expenses was due primarily to an increase of $6,381,000 in the reserve for doubtful accounts recorded in the second quarter, the hiring of additional employees for the expansion of our Asian operation and additional legal costs related to our litigation with Pro-Fit Holdings Limited. Unless this case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

General and administrative expenses increased approximately $9,088,000 to $14,736,000 for the six months ended June 30, 2005 from $5,648,000 for the six months ended June 30, 2004 due to the same factors discussed above.

Net interest expense increased approximately $124,000, or 86.1%, to $268,000 for the three months ended June 30, 2005 from $144,000 for the three months ended June 30, 2004. The interest expense increase was primarily due to higher debt levels. Borrowings under our UPS Capital credit facility decreased during the period ended June 30, 2004 due to proceeds received from our private placement transactions in May and December 2003 in which we raised approximately

$29 million from the sale of common and convertible preferred stock. In November 2004, we raised $12.5 million from the sale of 6% secured convertible notes payable.

Net interest expense increased approximately $206,000, or 62.2%, to $537,000 for the six months ended June 30, 2005 from $331,000 for the six months ended June 30, 2004. Borrowings under our UPS Capital credit facility decreased during the period ended June 30, 2004 due to proceeds received from our private placement transactions in May and December 2003 in which we raised approximately $29 million from the sale of common and convertible preferred stock. In November 2004, we raised $12.5 million from the sale of 6% secured convertible notes payable.

The provision for income taxes for the three months ended June 30, 2005 amounted to approximately $1,301,000 compared to $84,000 for the three months ended June 30, 2004. The provision for income taxes increased for the three months ended June 30, 2005 primarily due to an increase in our deferred tax asset valuation allowance and to taxes provided for earned income in our foreign subsidiary. Based on our net operating losses, there is not sufficient evidence to determine that it is more likely than not that we will be able to utilize our net operating loss carry forwards to offset future taxable income.

The provision for income taxes for the six months ended June 30, 2005 amounted to approximately $1,463,000 compared to an income tax benefit of $188,000 for the six months ended June 30, 2004. Income taxes increased for the six months ended June 30, 2005 due to an increase in our deferred tax asset valuation allowance and to taxes provided for earned income in our foreign subsidiary. Based on our net operating losses, there is not sufficient evidence to determine that it is more likely than not that we will be able to utilize our net operating loss carry forwards to offset future taxable income.

Net loss was approximately $11,260,000 for the three months ended June 30, 2005 as compared to net income of $170,000 for the three months ended June 30, 2004. Net loss was approximately

$12,909,000 for the six months ended June 30, 2005 as compared to a net loss of $382,000 for the six months ended June 30, 2004.

Preferred stock dividends amounted to $31,000 for the six months ended June 30, 2004. There were no preferred stock dividends for the six months ended June 30, 2005. Preferred stock dividends represent earned dividends at 6% of the stated value per annum of the Series C convertible redeemable preferred stock. In February 2004, the holders of the Series C convertible redeemable preferred stock converted all 759,494 shares of the Series C Preferred Stock, plus $458,707 of accrued dividends, into 700,144 shares of our common stock. Net loss available to common shareholders amounted to $12,909,000 for the six months ended June 30, 2005 compared to $412,000 for the six months ended June 30, 2004. Basic and diluted loss per share was $0.71 for the six months ended June 30, 2005 and $0.02 for the six months ended June 30, 2004. Net loss available to common shareholders was $11,260,000 for the three months ended June 30, 2005 compared to net income available to common shareholders of $170,000 for the three months ended June 30, 2004. Basic and diluted earnings (loss) per share was ($0.62) for the three months ended June 30, 2005 compared to $0.01 for the three months ended June 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents decreased to $2,962,000 at June 30, 2005 from $5,461,000 at December 31, 2004. The decrease resulted from approximately $148,000 of cash used by operating activities, $1,249,000 of cash used in investing activities and $1,102,000 of cash used in financing activities.

Net cash used in operating activities was approximately $148,000 for the six months ended June 30, 2005 and approximately $7,118,000 for the six months ended June 30, 2004. Cash used in operating activities for the six months ended June 30, 2005 resulted primarily from the net loss and increased inventories and accounts receivable before the increase in allowance for doubtful accounts of $6,121,000, partially offset by increased accounts payables and accrued expenses. The increase in accounts receivable during the period was due primarily to increased sales. Cash used in operating activities for the six months ended June 30, 2004 resulted primarily from increased accounts receivable and inventories.

Net cash used in investing activities was approximately $1,249,000 and $337,000 for the six months ended June 30, 2005 and 2004, respectively. Net cash used in investing activities for the six months ended June 30, 2005 consisted primarily of capital expenditures for TALON zipper equipment and leasehold improvements related to our new TALON manufacturing facility in North Carolina. Net cash used in investing activities for the six months ended June 30, 2004 consisted primarily of capital expenditures for computer equipment and the purchase of additional TALON zipper equipment.

Net cash used in financing activities was approximately $1,102,000 and $1,635,000 for the six months ended June 30, 2005 and 2004, respectively. Net cash used in financing activities for the six months ended June 30, 2005 primarily reflects the repayment of capital lease obligations and notes payable, offset by funds raised from the exercise of stock options and warrants and increased borrowings under our factoring arrangement. Net cash used in financing activities for the six months ended June 30, 2004 primarily reflects the repayment of borrowings under our credit facility and subordinated notes payable, offset by funds raised from the exercise of stock options and warrants.

We currently satisfy our working capital requirements primarily through cash flows generated from collection of our accounts receivables, sales of equity securities and borrowings from institutional investors and individual accredited investors. On November 10, 2004, we paid off our working capital credit facility with UPS Capital Global Trade Finance Corporation with a portion of the proceeds received from a private placement of $12.5 million of Secured Convertible Promissory Notes. The Secured

Convertible Promissory Notes are convertible into common stock at a price of $3.65 per share, bear interest at 6% payable quarterly, are due November 9, 2007 and are secured by the TALON trademarks. The Notes are convertible at the option of the holder at any time after closing. We may repay the Notes at any time after one year from the closing date with a 15% prepayment penalty. At maturity, we may repay the Notes in cash or require conversion if certain conditions are met. In connection with the issuance of the Notes, we issued to the Note holders warrants to purchase up to 171,235 shares of common stock. The warrants have a term of five years, an exercise price of $3.65 per share and vested 30 days after closing. We have registered with the SEC, the resale by the holders of the shares issuable upon conversion of the Notes and exercise of the warrants.

Amounts borrowed under our foreign factoring agreement as of June 30, 2005 amounted to approximately $1,001,000. At June 30, 2004, outstanding

borrowings under our UPS Capital credit facility, including amounts borrowed under our foreign factoring agreement, amounted to approximately $5,935,000. Open letters of credit under our UPS Capital credit facility at June 30, 2004 amounted to $481,000. There were no open letters of credit under our UPS Capital credit facility at June 30, 2005.

In 2005, we entered into a letter of credit facility with Wells Fargo Bank. This facility provides for letters of credit up to a maximum of $1.5 million, expires in November 2005 and is secured by cash on hand managed by Wells Fargo Bank. At June 30, 2005, outstanding letters of credit under the Wells Fargo facility amounted to $50,000.

Pursuant to the terms of a factoring agreement for our Hong Kong subsidiary, Tag-It Pacific Limited, the factor purchases our eligible accounts receivable and assumes the credit risk with respect to those accounts for which the factor has given its prior approval. If the factor does not assume the credit risk for a receivable, the collection risk associated with the receivable remains with us. We pay a fixed commission rate and may borrow up to 80% of eligible accounts receivable. Interest is charged at 1.5% over the Hong Kong Dollar prime rate. As of June 30, 2005 and 2004, the amount factored with recourse and included in trade accounts receivable was approximately $2,163,000 and $883,000. Outstanding advances as of June 30, 2005 and 2004 amounted to approximately $1,001,000 and $215,000 and are included in the line of credit balance.

As we continue to respond to the current industry trend of large retail brands to outsource apparel manufacturing to offshore locations, our foreign customers, though backed by U.S. brands and retailers, are increasing. This makes receivables based financing with traditional U.S. banks more difficult. Our current borrowings may not provide the level of financing we may need to expand into additional foreign markets. As a result, we are continuing to evaluate non-traditional financing of our foreign assets.

Our trade receivables, net of allowance for doubtful accounts, decreased to $13,353,000 at June 30, 2005 from $20,396,000 at June 30, 2004 primarily due to an increase of $6,381,000 in our allowance for doubtful account and a net decrease in related party trade receivables resulting from decreased sales to related parties during the period and the write-off of outstanding accounts receivable obligations due from United Apparel Ventures and its affiliate, Tarrant Apparel Group, during the fourth quarter of 2004. Following negotiations with United Apparel Ventures and its affiliate, Tarrant Apparel Group, a former major customer of ours, we determined that a significant portion of the obligations due from this customer were uncollectible. This resulted in a write-off of $6.9 million of accounts receivable due from Tarrant and UAV in the fourth quarter of 2004 and a net receivable balance due from UAV of $4.5 million at December 31, 2004. UAV agreed to pay the $4.5 million receivable balance over an eight-month period beginning May 2005. At June 30, 2005, the receivable balance due from Tarrant and UAV totaled $3.4 million. The decrease in receivables was offset by a net increase in non-related party receivables of approximately $680,000. This increase in non-related party receivables was due to increased sales to non-related party customers.

Our net deferred tax asset at June 30, 2005 was zero compared to $2.8 million at June 30, 2004. The decrease resulted from increases in our deferred tax asset valuation allowance as a result of our conclusion that it was not likely we would realize the benefits in the foreseeable future. The decrease in the net deferred tax asset resulted in a charge of $1.0 million against the

provision for income taxes for the second quarter. At December 31, 2004, we had Federal and state net operating loss carry forwards of approximately $21.6 million and $12.9 million, respectively, available to offset future taxable income. Our net operating losses may be limited in future periods if the ownership of the Company changes by more than 50% within a three-year period. As of December 31, 2004, some of our net operating losses may be limited by the Section 382 rules. The amount of such limitations, if any, has not yet been determined.

We have incurred significant legal fees in our litigation with Pro-Fit Holdings Limited. Unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

We believe that our existing cash and cash equivalents and anticipated cash flows from our operating activities and available financing will be sufficient to fund our minimum working capital and capital expenditure needs for at least the next twelve months. The extent of our future capital requirements will depend on many factors, including our results of operations, future demand for our products, the size and timing of future acquisitions and our expansion into foreign markets. Our need for additional long-term financing includes the integration and expansion of our operations to exploit our rights under our TALON trade name, the expansion of our operations in the Asian, Central and South American and Caribbean markets and the further development of our waistband technology. If our cash from operations is less than anticipated or our working capital requirements and capital expenditures are greater than we expect, we may need to raise additional debt or equity financing in order to provide for our operations. We are continually evaluating various financing strategies to be used to expand our business and fund future growth or acquisitions. There can be no assurance that additional debt or equity financing will be available on acceptable terms or at all. If we are unable to secure additional financing, we may not be able to execute our plans for expansion, including expansion into foreign markets to promote our TALON brand trade name, and we may need to implement additional cost savings initiatives.

CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

During the six months ended June 30, 2005, future minimum payments due under operating lease agreements increased by approximately $407,000. This increase was due to new lease agreements entered into by the Company related primarily for leased warehouse space.

At June 30, 2005 and 2004, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

RELATED PARTY TRANSACTIONS

Gerard Guez and Todd Kay, executive officers and significant shareholders of Tarrant Apparel Group, are significant stockholders of ours. Total sales to Tarrant Apparel Group and its affiliate, United Apparel Ventures, amounted to approximately $27,000 and $150,000 for the six months ended June 30, 2005 and 2004, respectively. As of June 30, 2004, accounts receivable related party included approximately $6,738,000 due from Tarrant and its affiliate. As of June 30, 2005, accounts receivable, related party included $3.4 million due from Tarrant's affiliate, United Apparel Ventures. United Apparel Ventures agreed to pay its remaining balance over an eight-month period beginning May 2005.

As of June 30, 2005 and 2004, we had outstanding related-party debt of approximately $665,000 and $850,000, at interest rates ranging from 7% to 11%, and additional non-related-party debt of $25,200 at an interest rate of 10%. The majority of related-party debt is due on demand, with the remainder due and payable on the fifteenth day following the date of delivery of written demand for payment.

NEW ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued Statement of Financial Accounting Standard ("SFAS") No. 123R "Share Based Payment." This statement is a revision of SFAS Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. This statement is effective as of the beginning of the first annual reporting period that begins after June 15, 2005. We have evaluated the effects of the adoption of this pronouncement and have determined it will not have a material impact on our financial statements.

In March, 2005, the Securities and Exchange Commission's ("SEC") Office of the Chief Accountant and its Division of Corporation Finance released Financial Accounting Bulletin No. 107, "Share-Based Payment" (SAB 107). SAB 107 provides interpretive guidance related to the interaction between Statement of Financial Accounting Standard No. 123R "Shared Based Payment" (SFAS 123R) and certain SEC rules and regulations. SAB 107 provides the staff's views regarding the valuation of shared-based payment arrangements for public companies and stresses the importance of including appropriate disclosures within SEC filings, particularly during the transition to SFAS 123R.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" ("APB 20") and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements for voluntary changes in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The impact of SFAS 154 will depend on the accounting change, if any, in a future period.

CAUTIONARY STATEMENTS AND RISK FACTORS

Several of the matters discussed in this document contain forward-looking statements that involve risks and uncertainties. Factors associated with the forward-looking statements that could cause actual results to differ from those projected or forecast are included in the statements below. In addition to other information contained in this report, readers should carefully consider the following cautionary statements and risk factors.

OUR GROWTH AND OPERATING RESULTS COULD BE MATERIALLY, ADVERSELY

EFFECTED IF WE ARE UNSUCCESSFUL IN RESOLVING A DISPUTE THAT NOW EXISTS REGARDING OUR RIGHTS UNDER OUR EXCLUSIVE LICENSE AND INTELLECTUAL PROPERTY AGREEMENT ("AGREEMENT") WITH PRO-FIT HOLDINGS. Pursuant to our Agreement with Pro-Fit Holdings Limited, we have exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. By letter dated April 6, 2004, Pro-Fit alleged various breaches of the Agreement

which we dispute. To prevent Pro-Fit in the future from terminating the Agreement based on alleged breaches that we do not regard as meritorious, we filed a lawsuit against Pro-Fit in the U.S. District Court for the Central District of California, based on various contractual and tort claims seeking declaratory relief, injunctive relief and damages. Pro-Fit filed an answer denying the material allegations of the complaint and filed a counterclaim alleging various contractual and tort claims seeking injunctive relief and damages. We filed a reply denying the material allegations of Pro-Fit's pleading. Pro-Fit has since purported to terminate our exclusive license and intellectual property agreement based on the same alleged breaches of the agreement that are the subject of our existing litigation, as well as on an additional basis unsupported by fact. In February 2005, we amended our pleadings in the litigation to assert additional breaches by Pro-Fit of its obligations to us under our agreement and under certain additional letter agreements, and for a declaratory judgment that Pro-Fit's patent No. 5,987,721 is invalid and not infringed by us. Thereafter, Pro-Fit filed an amended answer and counterclaim denying the material allegations of the amended complaint and alleging various contractual and tort claims seeking injunctive relief and damages. Pro-Fit further asserted that we infringed its United States Patent Nos. 5,987,721 and 6,566,285. We filed a reply denying the substantive allegations of the reply. At our request, the Court bifurcated the contract issues for trial to commence on January 10, 2006. The remaining issues will be tried at a later date. Fact discovery has been completed and expert discovery is ongoing.

We derive a significant amount of revenues from the sale of products incorporating the stretch waistband technology. Our business, results of operations and financial condition could be materially adversely affected if we are unable to conclude our present negotiations in a manner acceptable to us and ensuing litigation is not resolved in a manner favorable to us. Additionally, we have incurred significant legal fees in this litigation, and unless the case is settled, we will continue to incur additional legal fees in increasing amounts as the case accelerates to trial.

FAILURE TO MANAGE OUR CORPORATE RESTRUCTURING COULD IMPAIR OUR BUSINESS. In an effort to better align our organizational and cost structures with our future growth opportunities, in August 2005 our Board of Directors adopted a restructuring plan for our company that we expect will be completed in December 2005. The plan includes reorganizing our global operations by eliminating redundancies in our Hong Kong operation, reducing the functions performed at our Mexico facilities, converting our Guatemala facility from a manufacturing site to a distributor, and closing our North Carolina manufacturing facility. While we expect that the restructuring will result in reduced operating costs and improved operating results and cash flows, there can be no assurance that these results will be achieved. In addition, we expect to record a restructuring charge during the third quarter of 2005 of between $4 and $5 million. We face many challenges related to our decision implement the restructuring plan, including that we may not execute the restructuring effectively, and our expectation that we will benefit from greater efficiencies

may not be realized. Any failure on our part to successfully manage these challenges or other unanticipated consequences may result in loss of customers and sales, which could cause our results to differ materially from management's current expectations. The challenges we face include:

- Our ability to execute successfully through business cycles while we continue to implement the restructuring plan and cost reductions;
- Our ability to meet and achieve the benefits of our cost-reduction goals and otherwise successfully adapt our cost structures to continuing changes in business conditions;
- The risk that our cost-cutting initiatives will impair our ability to develop products and remain competitive and to operate effectively;
- We may experience delays in implementation of anticipated workforce reductions in highly regulated locations outside of the United States;

- We may experience decreases in employee morale; and
- We may experience unanticipated expenses in winding down manufacturing operations, including labor costs, which may adversely affect our results of operations in the short term.

IF WE LOSE OUR LARGER CUSTOMERS OR THEY FAIL TO PURCHASE AT ANTICIPATED LEVELS, OUR SALES AND OPERATING RESULTS WILL BE ADVERSELY AFFECTED. Our results of operations will depend to a significant extent upon the commercial success of our larger customers. If these customers fail to purchase our trim products at anticipated levels, or our relationship with these customers terminates, it may have an adverse affect on our results because:

- We will lose a primary source of revenue if these customers choose not to purchase our products or services;
- We may not be able to reduce fixed costs incurred in developing the relationship with these customers in a timely manner;
- We may not be able to recoup setup and inventory costs;
- We may be left holding inventory that cannot be sold to other customers; and
- We may not be able to collect our receivables from them.

WE MAY NOT BE ABLE TO ENFORCE THE MINIMUM PURCHASE REQUIREMENTS AND OTHER OBLIGATIONS OF OUR TALON DISTRIBUTORS. Expansion of our TALON zipper business depends in a large part on what we refer to as our TALON franchise strategy. We appoint distributors in various geographic international regions to finish and sell zippers under the TALON brand name. In return for the exclusive right to finish and sell zippers in selected territories, each distributor agrees to purchase a minimum quantity of zipper components from us over the term of our agreement. These distributors are foreign entities located primarily in emerging markets in Asia, Latin America, the Middle East and Africa. Despite a

distributor's contractual commitments to us, we may be unable to enforce the distributor's minimum purchase guarantee or recover damages or other relief following a default, which could result in lower than projected revenues for our TALON division.

CONCENTRATION OF RECEIVABLES FROM OUR LARGER CUSTOMERS MAKES RECEIVABLE BASED FINANCING DIFFICULT AND INCREASES THE RISK THAT IF OUR LARGER CUSTOMERS FAIL TO PAY US, OUR CASH FLOW WOULD BE SEVERELY AFFECTED. Our business relies heavily on a relatively small number of customers. This concentration of our business reduces the amount we can borrow from our lenders under receivables based financing agreements. Under a borrowing base credit agreement, for instance, if accounts receivable due us from a particular customer exceed a specified percentage of the total eligible accounts receivable against which we can borrower, the lender will not lend against the receivables that exceed the specified percentage. If we are unable to collect any large receivables due us, our cash flow would be severely impacted.

IF CUSTOMERS DEFAULT ON BUYBACK AGREEMENTS WITH US, WE WILL BE LEFT HOLDING NON-SALABLE INVENTORY. Inventories include goods that are subject to buyback agreements with our customers. Under these buyback agreements, some of our customers are required to purchase inventories from us under normal invoice and selling terms, if any inventory which we purchase on their behalf remains in our hands longer than agreed by the customer from the time we received the goods from our vendors. If any customer defaults on these buyback provisions or insists on markdowns, we may incur a charge in connection with our holding significant amounts of non-salable inventory and this would have a negative impact on our income.

OUR REVENUES MAY BE HARMED IF GENERAL ECONOMIC CONDITIONS WORSEN. Our revenues depend on the health of the economy and the growth of our customers and potential future customers. When economic conditions weaken, certain apparel manufacturers and retailers, including some of our customers, have experienced in the past, and may experience in the future, financial difficulties which increase the risk of extending credit to such customers. Customers adversely affected by economic conditions have also attempted to improve their own operating efficiencies by concentrating their purchasing power among a narrowing group of vendors. There can be no assurance that we will remain a preferred vendor to our existing customers. A decrease in business from or loss of a major customer could have a material adverse effect on our results of operations. Further, if the economic conditions in the United States worsen or if a wider or global economic slowdown occurs, we may experience a material adverse impact on our business, operating results, and financial condition.

BECAUSE WE DEPEND ON A LIMITED NUMBER OF SUPPLIERS, WE MAY NOT BE ABLE TO ALWAYS OBTAIN MATERIALS WHEN WE NEED THEM AND WE MAY LOSE SALES AND CUSTOMERS. Lead times for materials we order can vary significantly and depend on many factors, including the specific supplier, the contract terms and the demand for particular materials at a given time. From time to time, we may experience fluctuations in the prices, and disruptions in the supply, of materials. Shortages or disruptions in the supply of materials, or our inability to procure materials from alternate sources at acceptable prices in a timely manner, could lead us to miss deadlines for orders and lose sales and customers.

IF WE ARE NOT ABLE TO MANAGE OUR RAPID EXPANSION AND GROWTH, WE COULD INCUR UNFORESEEN COSTS OR DELAYS AND OUR REPUTATION AND RELIABILITY IN THE MARKETPLACE AND OUR REVENUES WILL BE ADVERSELY AFFECTED. The growth of our operations and activities has placed and will continue to place a significant

strain on our management, operational, financial and accounting resources. If we cannot implement and improve our financial and management information and reporting systems, we may not be able to implement our growth strategies successfully and our revenues will be adversely affected. In addition, if we cannot hire, train, motivate and manage new employees, including management and operating personnel in sufficient numbers, and integrate them into our overall operations and culture, our ability to manage future growth, increase production levels and effectively market and distribute our products may be significantly impaired.

WE OPERATE IN AN INDUSTRY THAT IS SUBJECT TO SIGNIFICANT FLUCTUATIONS IN OPERATING RESULTS THAT MAY RESULT IN UNEXPECTED REDUCTIONS IN REVENUE AND STOCK PRICE VOLATILITY. We operate in an industry that is subject to significant fluctuations in operating results from quarter to quarter, which may lead to unexpected reductions in revenues and stock price volatility. Factors that may influence our quarterly operating results include:

- The volume and timing of customer orders received during the quarter;
- The timing and magnitude of customers' marketing campaigns;
- The loss or addition of a major customer;
- The availability and pricing of materials for our products;
- The increased expenses incurred in connection with the introduction of new products;
- Currency fluctuations;
- Delays caused by third parties; and
- Changes in our product mix or in the relative contribution to sales of our subsidiaries.

Due to these factors, it is possible that in some quarters our operating results may be below our stockholders' expectations and those of public market analysts. If this occurs, the price of our common stock would likely be adversely affected.

OUR CUSTOMERS HAVE CYCLICAL BUYING PATTERNS WHICH MAY CAUSE US TO HAVE PERIODS OF LOW SALES VOLUME. Most of our customers are in the apparel industry. The apparel industry historically has been subject to substantial cyclical variations. Our business has experienced, and we expect our business to continue to experience, significant cyclical fluctuations due, in part, to customer buying patterns, which may result in periods of low sales usually in the first and fourth quarters of our financial year.

OUR BUSINESS MODEL IS DEPENDENT ON INTEGRATION OF INFORMATION SYSTEMS ON A GLOBAL BASIS AND, TO THE EXTENT THAT WE FAIL TO MAINTAIN AND SUPPORT OUR INFORMATION SYSTEMS, IT CAN RESULT IN LOST REVENUES. We must consolidate and centralize the management of our subsidiaries and significantly expand and improve our financial and operating controls. Additionally, we must effectively integrate the information systems of our Hong Kong, Mexico and Caribbean facilities with the information systems of our principal offices in California. Our failure to do so could result in lost revenues, delay financial reporting or

adversely affect availability of funds under our credit facilities.

THE LOSS OF KEY MANAGEMENT AND SALES PERSONNEL COULD ADVERSELY AFFECT OUR BUSINESS, INCLUDING OUR ABILITY TO OBTAIN AND SECURE ACCOUNTS AND GENERATE SALES. Our success has and will continue to depend to a significant extent upon key management and sales personnel, many of whom would be difficult to replace, particularly Colin Dyne, our Chief Executive Officer. Colin Dyne is not bound by an employment agreement. The loss of the services of Colin Dyne or the services of other key employees could have a material adverse effect on our business, including our ability to establish and maintain client relationships. Our future success will depend in large part upon our ability to attract and retain personnel with a variety of sales, operating and managerial skills.

IF WE EXPERIENCE DISRUPTIONS AT ANY OF OUR FOREIGN FACILITIES, WE WILL NOT BE ABLE TO MEET OUR OBLIGATIONS AND MAY LOSE SALES AND CUSTOMERS. Currently, we do not operate duplicate facilities in different geographic areas. Therefore, in the event of a regional disruption where we maintain one or more of our facilities, it is unlikely that we could shift our operations to a different geographic region and we may have to cease or curtail our operations. This may cause us to lose sales and customers. The types of disruptions that may occur include:

- Foreign trade disruptions;
- Import restrictions;
- Labor disruptions;
- Embargoes;
- Government intervention; and
- Natural disasters.

INTERNET-BASED SYSTEMS THAT HOST OUR MANAGED TRIM SOLUTION MAY EXPERIENCE DISRUPTIONS AND AS A RESULT WE MAY LOSE REVENUES AND CUSTOMERS. Our MANAGED TRIM SOLUTION is an Internet-based business-to-business e-commerce system. To the extent that we fail to adequately continue to update and maintain the hardware and software implementing the MANAGED TRIM SOLUTION, our customers may experience interruptions in service due to defects in our hardware or our source code. In addition, since our MANAGED TRIM SOLUTION is Internet-based, interruptions in Internet service generally can negatively impact our customers' ability to use the MANAGED TRIM SOLUTION to monitor and manage various aspects of their trim needs. Such defects or interruptions could result in lost revenues and lost customers.

THERE ARE MANY COMPANIES THAT OFFER SOME OR ALL OF THE PRODUCTS AND SERVICES WE SELL AND IF WE ARE UNABLE TO SUCCESSFULLY COMPETE OUR BUSINESS WILL BE ADVERSELY AFFECTED. We compete in highly competitive and fragmented industries with numerous local and regional companies that provide some or all of the products and services we offer. We compete with national and international design companies, distributors and manufacturers of tags, packaging products, zippers and other trim items. Some of our competitors, including Paxar Corporation, YKK, Universal Button, Inc., Avery Dennison Corporation and Scovill Fasteners, Inc., have greater name recognition, longer operating histories and, in many cases, substantially greater financial and other resources than we do.

UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY MAY INCREASE OUR LITIGATION COSTS AND ADVERSELY AFFECT OUR SALES. We rely on trademark, trade secret and copyright laws to protect our designs and other proprietary property worldwide. We cannot be certain that these laws will be sufficient to protect our property. In particular, the laws of some countries in which our products are distributed or may be distributed in the future may not protect our products and intellectual rights to the same extent as the laws of the United States. If litigation is necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others, such litigation could result in substantial costs and diversion of resources. This could have a material adverse effect on our operating results and financial condition. Ultimately, we may be unable, for financial or other reasons, to enforce our rights under intellectual property laws, which could result in lost sales.

IF OUR PRODUCTS INFRINGE ANY OTHER PERSON'S PROPRIETARY RIGHTS, WE MAY BE SUED AND HAVE TO PAY LARGE LEGAL EXPENSES AND JUDGMENTS AND REDESIGN OR DISCONTINUE SELLING OUR PRODUCTS. From time to time in our industry, third parties allege infringement of their proprietary rights. Any infringement claims, whether or not meritorious, could result in costly litigation or require us to enter into royalty or licensing agreements as a means of settlement. If we are found to have infringed the proprietary rights of others, we could be required to pay damages, cease sales of the infringing products and redesign the products or discontinue their sale. Any of these outcomes, individually or collectively, could have a material adverse effect on our operating results and financial condition.

OUR STOCK PRICE MAY DECREASE, WHICH COULD ADVERSELY AFFECT OUR BUSINESS AND CAUSE OUR STOCKHOLDERS TO SUFFER SIGNIFICANT LOSSES. The following factors could cause the market price of our common stock to decrease, perhaps substantially:

- The failure of our quarterly operating results to meet expectations of investors or securities analysts;
- Adverse developments in the financial markets, the apparel industry and the worldwide or regional economies;
- Interest rates;
- Changes in accounting principles;
- Sales of common stock by existing shareholders or holders of options;
- Announcements of key developments by our competitors; and
- The reaction of markets and securities analysts to announcements and developments involving our company.

IF WE NEED TO SELL OR ISSUE ADDITIONAL SHARES OF COMMON STOCK OR ASSUME ADDITIONAL DEBT TO FINANCE FUTURE GROWTH, OUR STOCKHOLDERS' OWNERSHIP COULD BE DILUTED OR OUR EARNINGS COULD BE ADVERSELY IMPACTED. Our business strategy may include expansion through internal growth, by acquiring complementary businesses or by establishing strategic relationships with targeted customers and

suppliers. In order to do so or to fund our other activities, we may issue additional equity securities that could dilute our stockholders' stock ownership. We may also assume additional debt and incur impairment losses related to goodwill and other tangible assets if we acquire another company and this could negatively impact our results of operations.

WE MAY NOT BE ABLE TO REALIZE THE ANTICIPATED BENEFITS OF ACQUISITIONS. We may consider strategic acquisitions as opportunities arise, subject to the obtaining of any necessary financing. Acquisitions involve numerous risks, including diversion of our management's attention away from our operating activities. We cannot assure our stockholders that we will not encounter unanticipated problems or liabilities relating to the integration of an acquired company's operations, nor can we assure our stockholders that we will realize the anticipated benefits of any future acquisitions. We currently do not have any plans to pursue any potential acquisitions.

WE HAVE ADOPTED A NUMBER OF ANTI-TAKEOVER MEASURES THAT MAY DEPRESS THE PRICE OF OUR COMMON STOCK. Our stockholders' rights plan, our ability to issue additional shares of preferred stock and some provisions of our certificate of incorporation and bylaws and of Delaware law could make it more difficult for a third party to make an unsolicited takeover attempt of us. These anti-takeover measures may depress the price of our common stock by making it more difficult for third parties to acquire us by offering to purchase shares of our stock at a premium to its market price.

INSIDERS OWN A SIGNIFICANT PORTION OF OUR COMMON STOCK, WHICH COULD LIMIT OUR STOCKHOLDERS' ABILITY TO INFLUENCE THE OUTCOME OF KEY TRANSACTIONS. As of August 1, 2005, our officers and directors and their affiliates beneficially owned approximately 15.1% of the outstanding shares of our common stock. The Dyne family, which includes Mark Dyne, Colin Dyne, Larry Dyne, Jonathan Burstein and the estate of Harold Dyne, beneficially owned approximately 17.9% of the outstanding shares of our common stock at August 1, 2005. As a result, our officers and directors and the Dyne family are able to exert considerable influence over the outcome of any matters submitted to a vote of the holders of our common stock, including the election of our Board of Directors. The voting power of these stockholders could also discourage others from seeking to acquire control of us through the purchase of our common stock, which might depress the price of our common stock.

WE MAY FACE INTERRUPTION OF PRODUCTION AND SERVICES DUE TO INCREASED SECURITY MEASURES IN RESPONSE TO TERRORISM. Our business depends on the free flow of products and services through the channels of commerce. Recently, in response to terrorists' activities and threats aimed at the United States, transportation, mail, financial and other services have been slowed or stopped altogether. Further delays or stoppages in transportation, mail, financial or other services could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may experience an increase in operating costs, such as costs for transportation, insurance and security as a result of the activities and potential activities. We may also experience delays in receiving payments from payers that have been affected by the terrorist activities and potential activities. The United States economy in general is being adversely affected by the terrorist activities and potential activities and any economic downturn could adversely impact our results of operations, impair our ability to raise capital or otherwise adversely affect our ability to grow our business.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

All of our sales are denominated in United States dollars or the currency of the country in which our products originate. We are exposed to market risk for fluctuations in the foreign currency exchange rates for certain product purchases that are denominated in British Pounds. During 2004, we

purchased forward exchange contracts for British Pounds to hedge the payments of product purchases. We intend to purchase additional contracts to hedge the British Pound exposure for future product purchases. There

were no hedging contracts outstanding as of June 30, 2005. Currency fluctuations can increase the price of our products to foreign customers which can adversely impact the level of our export sales from time to time. The majority of our cash equivalents are held in United States bank accounts and we do not believe we have significant market risk exposure with regard to our investments.

We are also exposed to the impact of interest rate changes on our outstanding borrowings. At June 30, 2005, we had approximately $1.2 million of indebtedness subject to interest rate fluctuations. These fluctuations may increase our interest expense and decrease our cash flows from time to time. For example, based on average bank borrowings of $10 million during a three-month period, if the interest rate indices on which our bank borrowing rates are based were to increase 100 basis points in the three-month period, interest incurred would increase and cash flows would decrease by $25,000.

ITEM 4. CONTROLS AND PROCEDURES.

EVALUATION OF CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures, which we have designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding disclosure. In response to recent legislation and proposed regulations, we reviewed our internal control structure and our disclosure controls and procedures.

In the course of conducting its review of our financial statements for the fiscal quarter ended June 30, 2005, our independent auditors, BDO Seidman, LLP informed members of our senior management and the Audit Committee of our Board of Directors that they had discovered significant deficiencies in our internal control over financial reporting that alone and in the aggregate constituted a "material weakness," which is defined under standards established by the Public Company Accounting Oversight Board as a deficiency that could result in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The deficiencies identified consisted of our recording post-closing adjustments in our financial statements for the quarter ended June 30, 2005 related to the allowance for doubtful accounts, reserve for inventory obsolescence, and deferred tax asset, which were identified by BDO Seidman, LLP in connection with its review of the financial statements, indicating a material weakness in our quarterly financial statement closing process. BDO Seidman, LLP identified the same material weakness in our annual financial statement closing process in connection with its audit of our financial statements for the fiscal year ended December 31, 2004. In order to address this material weakness identified in the annual financial statement closing process, we implemented additional review procedures over the selection and monitoring of appropriate assumptions and estimates affecting these accounting practices. There were no post-closing adjustments as of March 31, 2005, the first quarterly period following implementation of additional review procedures. The deficiencies,

however, were again present in the closing process for our financial statements for the second quarter of 2005.

Members of management, including the Company's Chief Executive Officer, Colin Dyne, and Chief Financial Officer, August DeLuca, have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2005, the end of the period covered by this report. Based upon that evaluation, because of the material weakness described above, Mr. Dyne and Mr. Deluca were unable to conclude that the Company's disclosure controls and procedures were effective as of June 30, 2005. Management has identified the steps necessary to address the material weaknesses as

described above, and will continue to implement remediation plans. We believe these corrective actions, taken as a whole, have mitigated the control deficiencies with respect to our preparation of this Quarterly Report and that these measures have been effective to ensure that the information required to be disclosed in this Quarterly Report has been recorded, processed, summarized and reported correctly.

CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING

There were no significant changes in our internal controls over financial reporting that occurred during the second quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

As previously reported, including in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, we have filed suit against Pro-Fit Holdings Limited in the U.S. District Court for the Central District of California -- Tag-It Pacific, Inc. v. Pro-Fit Holdings Limited, CV 04-2694 LGB (RCx) - based on various contractual and tort claims relating to our exclusive license and intellectual property agreement, seeking declaratory relief, injunctive relief and damages. The agreement with Pro-Fit gives us exclusive rights in certain geographic areas to Pro-Fit's stretch and rigid waistband technology. Pro-Fit filed an answer denying the material allegations of the complaint and filed a counterclaim alleging various contractual and tort claims seeking injunctive relief and damages. We filed a reply denying the material allegations of Pro-Fit's pleading. Pro-Fit has since purported to terminate the exclusive license and intellectual property agreement based on the same alleged breaches of the agreement that are the subject of the parties' existing litigation, as well as on an additional basis unsupported by fact. In February 2005, we amended our pleadings in the litigation to assert additional breaches by Pro-Fit of its obligations to us under the agreement and under certain additional letter agreements, and for a declaratory judgment that Pro-Fit's patent No. 5,987,721 is invalid and not infringed by us. Thereafter, Pro-Fit filed an amended answer and counterclaim denying the material allegations of the amended complaint and alleging various contractual and tort claims seeking injunctive relief and damages. Pro-Fit further asserted that we infringed its United States Patent Nos. 5,987,721 and 6,566,285. We filed a reply denying the substantive allegations of the reply. At our request, the Court bifurcated the contract issues for trial to commence on January 10, 2006. The remaining issues

will be tried at a later date. Fact discovery has been completed and expert discovery is ongoing.

We currently have pending a number of other claims, suits and complaints that arise in the ordinary course of our business. We believe that we have meritorious defenses to these claims and that the claims are either covered by insurance or, after taking into account the insurance in place, would not have a material effect on our consolidated financial condition if adversely determined against us.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

At our Annual Meeting of Stockholders held on June 14, 2005 our stockholders (a) elected Jonathan Burstein and Michael Katz to serve as Class II Directors on our Board of Directors for three years and until their respective successors have been elected. Jonathan Burstein was elected by a vote of 13,845,379 shares in favor and 3,249,805 shares were withheld from voting for the director. Michael Katz was elected by a vote of 13,900,807 shares in favor and 3,194,377 shares were withheld from voting for the director. There were no broker non-votes at the annual meeting. Immediately prior to the meeting, the Board of Directors was comprised of Mark Dyne, Colin Dyne, Kevin Bermeister, Brent Cohen, Michael Katz, Jonathan Burstein, Raymond Musci and Joseph Miller. Immediately following the

meeting, the Board of Directors was comprised of Mark Dyne, Colin Dyne, Kevin Bermeister, Brent Cohen, Michael Katz, Jonathan Burstein, Raymond Musci, Joseph Miller and Susan White.

ITEM 6. EXHIBITS.

31.1 Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended

31.2 Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended

32.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.

SIGNATURES

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

Dated: August 22, 2005

TAG-IT PACIFIC, INC.

/S/ AUGUST DELUCA

By: August DeLuca

Its: Chief Financial Officer