CARTERS INC
Form 10-Q
November 09, 2006

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 SEPTEMBER 30, 2006 OR

o 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:

001-31829

CARTER S, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**13-3912933**
(State or other jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

The Proscenium

1170 Peachtree Street NE, Suite 900

Atlanta, Georgia 30309

(Address of principal executive offices, including zip code)

(404) 745-2700

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o 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	**Outstanding Shares at November 9, 2006**
Common stock, par value $0.01 per share	58,868,080

CARTER S, INC.

INDEX

			Page
Part I.	**Financial Information**		
	Item 1.	Financial Statements	
		Unaudited Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005	3
		Unaudited Condensed Consolidated Statements of Operations for the three and nine-month periods ended September 30, 2006 and October 1, 2005	4
		Unaudited Condensed Consolidated Statements of Cash Flows for the nine-month periods ended September 30, 2006 and October 1, 2005	5
		Unaudited Condensed Consolidated Statement of Changes in Stockholders Equity for the nine-month period ended September 30, 2006	6
		Notes to the Unaudited Condensed Consolidated Financial Statements	7
	Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	23
	Item 3.	Quantitative and Qualitative Disclosures about Market Risk	38
	Item 4.	Controls and Procedures	39
Part II.	**Other Information**		
	Item 1.	Legal Proceedings	40
	Item 1A.	Risk Factors	40
	Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	40
	Item 3.	Defaults upon Senior Securities	40
	Item 4.	Submission of Matters to a Vote of Security Holders	40
	Item 5.	Other Information	40
	Item 6.	Exhibits	41
Signatures			42
Certifications			

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARTER S, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except for share data)

(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 29,956	$ 84,276
Accounts receivable, net	150,835	96,144
Inventories, net	199,849	188,454
Prepaid expenses and other current assets	9,696	6,262
Deferred income taxes	19,739	23,909
Total current assets	410,075	399,045
Property, plant, and equipment, net	79,863	79,458
Tradenames	322,233	322,233
Cost in excess of fair value of net assets acquired	279,756	284,172
Deferred debt issuance costs, net	6,797	8,257
Licensing agreements, net	13,959	17,150
Leasehold interests, net	1,268	1,619
Other assets	5,144	4,793
Total assets	$ 1,119,095	$ 1,116,727
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 2,984	$ 3,241
Accounts payable	44,395	63,735
Other current liabilities	79,151	89,627
Total current liabilities	126,530	156,603
Long-term debt	389,915	426,791
Deferred income taxes	126,145	124,439
Other long-term liabilities	22,111	22,250
Total liabilities	664,701	730,083
Commitments and contingencies		
Stockholders equity:		
Preferred stock; par value $.01 per share; 100,000 shares authorized; none issued or outstanding at September 30, 2006 and December 31, 2005		
Common stock, voting; par value $.01 per share; 150,000,000 shares authorized; 58,179,118 shares issued and outstanding at September 30, 2006; 40,000,000 shares authorized, 28,909,729 shares issued and outstanding at December 31, 2005	582	289
Additional paid-in capital	265,345	260,414
Deferred compensation		(2,749)
Accumulated other comprehensive income	1,350	1,354
Retained earnings	187,117	127,336
Total stockholders equity	454,394	386,644
Total liabilities and stockholders equity	$ 1,119,095	$ 1,116,727

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except for share data)

(unaudited)

	For the three-month periods ended		For the nine-month periods ended	
	September 30, 2006	**October 1, 2005**	**September 30, 2006**	**October 1, 2005**
Net sales	$ 391,977	$ 372,158	$ 966,001	$ 770,865
Cost of goods sold	244,757	243,497	613,382	500,374
Gross profit	147,220	128,661	352,619	270,491
Selling, general, and administrative expenses	93,496	89,303	258,944	192,542
Closure costs		1,509	91	6,078
Royalty income	(7,782)	(7,208)	(21,610)	(13,544)
Operating income	61,506	45,057	115,194	85,415
Loss on extinguishment of debt		20,137		20,137
Interest expense, net	6,554	7,444	20,367	15,902
Income before income taxes	54,952	17,476	94,827	49,376
Provision for income taxes	19,975	6,898	35,046	19,499
Net income	$ 34,977	$ 10,578	$ 59,781	$ 29,877
Basic net income per common share	$ 0.60	$ 0.18	$ 1.03	$ 0.52
Diluted net income per common share	$ 0.57	$ 0.17	$ 0.98	$ 0.49
Basic weighted-average number of shares outstanding	57,949,783	57,439,850	57,845,521	57,177,740
Diluted weighted-average number of shares outstanding	61,094,141	60,932,056	61,173,247	60,672,620

See accompanying notes to the unaudited condensed consolidated financial statements

4

CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(unaudited)

	For the nine-month periods ended September 30, 2006	October 1, 2005
Cash flows from operating activities:		
Net income	$ 59,781	$ 29,877
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	18,272	16,207
Loss on extinguishment of debt		20,137
Amortization of inventory step-up		10,370
Amortization of debt issuance costs	1,460	1,892
Accretion of debt discount		40
Income tax benefit from exercised stock options	(2,472)	5,184
Non-cash stock-based compensation expense	4,349	1,108
Non-cash closure costs		113
Loss (gain) on sale of property, plant, and equipment	197	(109)
Deferred income taxes	5,666	(3,134)
Effect of changes in operating assets and liabilities:		
Accounts receivable	(54,691)	(36,289)
Inventories	(11,395)	(14,627)
Prepaid expenses and other assets	(3,090)	(1,938)
Accounts payable and other liabilities	(23,310)	5,328
Net cash (used in) provided by operating activities	(5,233)	34,159
Cash flows from investing activities:		
Acquisition of OshKosh B Gosh, Inc., net of cash acquired		(309,910)
Capital expenditures	(15,861)	(10,650)
Proceeds from sale of property, plant, and equipment	348	528
Sale of investments		60,100
Purchase of investments		(50,175)
Collections on loan		2,954
Net cash used in investing activities	(15,513)	(307,153)
Cash flows from financing activities:		
Proceeds from new term loan		500,000
Payments on new term loan	(37,133)	(31,250)
Payments on former term loan		(71,326)
Borrowings from revolving loan facility	5,000	
Payments on revolving loan facility	(5,000)	
Repayment of 10.875% Senior Subordinated Notes		(113,750)
Payment of debt redemption premium		(14,015)
Payment of debt issuance costs		(10,780)
Income tax benefit from exercised stock options	2,472	-
Proceeds from exercise of stock options	1,087	1,593
Net cash (used in) provided by financing activities	(33,574)	260,472

Net decrease in cash and cash equivalents	(54,320)	(12,522)
Cash and cash equivalents, beginning of period	84,276	33,265
Cash and cash equivalents, end of period	$ 29,956	$ 20,743

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(dollars in thousands, except for share data)

(unaudited)

	Common stock	Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income	Retained earnings	Total stockholders equity
Balance at December 31, 2005	$ 289	$ 260,414	$ (2,749)	$ 1,354	$ 127,336	$ 386,644
Tax benefit from exercise of stock options		2,472				2,472
Exercise of stock options (252,288 shares)	2	1,085				1,087
Stock-based compensation expense		3,874				3,874
Issuance of common stock (17,172 shares)		540				540
Reversal of deferred compensation (see Note 9)		(2,749)	2,749			
Two-for-one common stock split (see Note 8)	291	(291)				
Comprehensive income:						
Net income					59,781	59,781
Unrealized gain on interest rate swap, net of taxes of $242				452		452
Unrealized loss on interest rate collar, net of tax benefit of $32				(456)		(456)
Total comprehensive income				(4)	59,781	59,777
Balance at September 30, 2006	$ 582	$ 265,345		$ 1,350	$ 187,117	$ 454,394

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1 THE COMPANY:

Carter s, Inc., and its wholly-owned subsidiaries (collectively, the Company, we, us, its, and our) design, source, and market branded childrenswear under the *Carter s, Child of Mine, Just One Year, OshKosh B Gosh*, and related labels. Our products are sourced through contractual arrangements with manufacturers worldwide. Products are sourced for wholesale distribution to major domestic retailers, including the mass channel, and for our 205 *Carter s* brand and 146 *OshKosh* brand retail stores that market our brand name merchandise and other licensed products manufactured by other companies.

On July 14, 2005, Carter s, Inc., through its wholly-owned subsidiary, The William Carter Company (TWCC), acquired all of the outstanding common stock of OshKosh B Gosh, Inc. for a purchase price of $312.1 million, which included payment for vested stock options (the Acquisition). The accompanying unaudited condensed consolidated financial statements include the operations of OshKosh for the three and nine-month periods ended September 30, 2006. Financial results for the three and nine-month periods ended October 1, 2005 include the operations of OshKosh for the period from July 14, 2005 through October 1, 2005.

NOTE 2 BASIS OF PREPARATION:

The accompanying unaudited condensed consolidated financial statements comprise the consolidated financial statements of Carter s, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

In our opinion, the Company s accompanying unaudited condensed consolidated financial statements contain all adjustments necessary for a fair statement of our financial position as of September 30, 2006, the results of our operations for the three and nine-month periods ended September 30, 2006 and October 1, 2005, cash flows for the nine-month periods ended September 30, 2006 and October 1, 2005 and changes in stockholders equity for the nine-month period ended September 30, 2006. Except as otherwise noted, all such adjustments consist only of those of a normal recurring nature. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending December 30, 2006. Our accompanying condensed consolidated balance sheet as of December 31, 2005 is from our audited consolidated financial statements included in our most recently filed Annual Report on Form 10-K, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Certain information and footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission and the instructions to Form 10-Q. The accounting policies we follow are set forth in our most recently filed Annual Report on Form 10-K in the notes to our consolidated financial statements for the fiscal year ended December 31, 2005.

Our fiscal year ends on the Saturday in December or January nearest to the last day of December. The accompanying unaudited condensed consolidated financial statements for the third quarter and first nine months of fiscal 2006 reflect our financial position as of September 30, 2006. The third quarter and first nine months of fiscal 2005 ended on October 1, 2005.

Certain prior year amounts have been reclassified for comparative purposes.

NOTE 3 BUSINESS COMBINATION AND REFINANCING:

As noted above, on July 14, 2005, we acquired all of the outstanding common stock of OshKosh. The Acquisition was accounted for under the purchase method of accounting. The purchase price for the Acquisition, including related fees and expenses, was allocated to the fair value of tangible and identifiable intangible assets and liabilities acquired with the remainder allocated to cost in excess of fair value of net assets acquired. As part of financing the Acquisition, the Company refinanced its existing debt (the Refinancing), including its senior credit facility (former senior credit facility) and repurchased $113.8 million of 10.875% Senior Subordinated Notes due 2011 (the Notes). The repurchase of the Notes together with the Refinancing and Acquisition is referred to as the Transaction.

Financing for the Transaction was provided by a new $500 million Term Loan 1 (see Note 6) and a $125 million revolving credit facility (including a sub-limit for letters of credit of $80 million, the Revolver) entered into by TWCC with Bank of America, N.A., as administrative agent, Credit Suisse, and certain other financial institutions (the Senior Credit Facility). The term of the Revolver extends to July 14, 2011 and the term of the Term Loan 1 extends to July 14, 2012.

The proceeds from the Refinancing were used to purchase the outstanding common stock and vested stock options of OshKosh ($312.1 million), pay transaction expenses ($6.2 million), refinance the Company s former senior credit facility ($36.2 million), repurchase the Notes ($113.8 million), pay a redemption premium on the Company s Notes ($14.0 million), along with accrued and unpaid interest ($5.1 million), and pay debt issuance costs ($10.6 million). Other Transaction expenses paid prior and subsequent to the closing of the Transaction totaled $1.4 million, including $0.2 million in debt issuance costs.

As a result of the Refinancing, we expensed $4.5 million in unamortized debt issuance costs related to the former senior credit facility and Notes and expensed $0.5 million related to the debt discount on the Notes. Additionally, we expensed approximately $1.1 million of debt issuance costs associated with the Senior Credit Facility in accordance with Emerging Issues Task Force (EITF) No. 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments.

The Senior Credit Facility requires us to hedge at least 25% of our variable rate debt under the Term Loan 1. On September 22, 2005, we entered into a swap agreement to receive floating interest and pay fixed interest. This swap agreement is designated as a cash flow hedge of the variable interest payments on a portion of our variable rate Term Loan 1 debt. The swap agreement matures on July 30, 2010. The unrealized (loss) gain, net of taxes, related to the interest rate swap was ($1.3) million and $0.5 million, respectively, for the three and nine-month periods ended September 30, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet. During the three and nine-month periods ended September 30, 2006, we reclassified approximately $0.5 million and $0.9 million, respectively, related to the swap agreement into earnings.

On May 25, 2006, we entered into an interest rate collar agreement (the collar) with a floor of 4.3% and a ceiling of 5.5%. The collar covers $100 million of our variable rate Term Loan 1 debt and is designated as a cash flow hedge of the variable interest payments on such debt. The collar matures on January 31, 2009. The unrealized loss, net of tax benefit, related to the collar was ($0.6) million and ($0.5) million, respectively, for the three and nine-month periods ended September 30, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet.

A summary of the Acquisition purchase price allocation is as follows:

(dollars in thousands)	
Cash and cash equivalents	$ 9,500
Investments	18,355
Accounts receivable	15,979
Inventory	86,201
Deferred tax assets	13,453
Property, plant, and equipment	26,107
Tradename	102,000
Licensing agreements	19,100
Leasehold interests	1,833
Other assets	5,075
Accounts payable	(19,052)
Severance and relocation (Note 11)	(9,733)
Other exit costs (Note 11)	(2,167)
Lease termination costs (Note 11)	(7,200)
Contract termination costs (Note 11)	(1,533)
Deferred tax liabilities	(41,800)
Accrued and other liabilities	(39,820)
Cost in excess of fair value of net assets acquired	143,186
	$ 319,484

The following unaudited pro forma summary presents information as if the Transaction occurred on the first day of fiscal 2005 and assumes that there were no other changes in our operations. This pro forma information does not necessarily reflect the actual results that would have occurred had the Transaction occurred on that date, nor is it necessarily indicative of the future results of operations of the combined Company.

The unaudited pro forma summary reflects the combined Company for the three and nine-month periods ended October 1, 2005, adjusted to reflect increased interest expense, amortization of the capitalized value of OshKosh licensing agreements and leasehold interests, and incremental depreciation expense.

(dollars in thousands, except share data)	**For the three-month period ended October 1, 2005**	**For the nine-month period ended October 1, 2005**
Pro forma net sales	$ 383,065	$ 944,191
Pro forma net income	$ 9,892	$ 20,909
Pro forma basic earnings per share	$ 0.17	$ 0.37
Pro forma diluted earnings per share	$ 0.16	$ 0.34

NOTE 4 COST IN EXCESS OF FAIR VALUE OF NET ASSETS ACQUIRED AND OTHER INTANGIBLE ASSETS:

In connection with the Acquisition, the Company recorded the cost in excess of fair value of net assets acquired and other intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations.

As of September 30, 2006, cost in excess of fair value of net assets acquired and other intangible assets resulting from the Acquisition were as follows:

(dollars in thousands)	**Weighted-average useful life**	**Gross amount**	**Accumulated amortization**
Cost in excess of fair value of net assets acquired	Indefinite	$ 143,186	$
OshKosh tradename	Indefinite	$ 102,000	$
OshKosh licensing agreements	4.7 years	$ 19,100	$ 5,141
Leasehold interests	4.1 years	$ 1,833	$ 565

During the three-month period ended September 30, 2006, approximately $0.7 million related to pre-Acquisition tax contingencies were reversed due to the closure of certain tax periods. This reversal resulted in a corresponding adjustment to cost in excess of fair value of net assets acquired of $0.7 million in accordance with EITF 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination (EITF 93-7).

Amortization expense for intangible assets subject to amortization was approximately $1.2 million and $3.5 million for the three and nine-month periods ended September 30, 2006. Annual amortization expenses for the OshKosh licensing agreements and leasehold interests are expected to be as follows:

(dollars in thousands) **Fiscal Year**	**Estimated amortization expense**
2006 (period from October 1 through December 30)	$ 1,180
2007	4,447
2008	4,106
2009	3,717
2010	1,777
Total	$ 15,227

As described in Note 2 to our consolidated financial statements in our most recently filed Annual Report on Form 10-K, our existing *Carter s* tradename and cost in excess of fair value of net assets acquired have been deemed to have indefinite lives and are not being amortized. During the three-month period ended September 30, 2006, approximately $2.7 million related to tax contingencies established in connection with the 2001 Acquisition of the Company by Berkshire Partners LLC (the 2001 Acquisition) were reversed due to the closure of certain tax periods. This reversal resulted in a corresponding adjustment to cost in excess of fair value of net assets acquired of $2.7 million in accordance with EITF 93-7.

10

NOTE 5 INVENTORIES:

Inventories consisted of the following:

(dollars in thousands)	September 30, 2006	December 31, 2005
Finished goods	$ 199,849	$ 185,472
Work in process		2,336
Raw materials and supplies		646
Total	$ 199,849	$ 188,454

NOTE 6 CREDIT FACILITY AMENDMENT:

On April 28, 2006, the Company entered into Amendment No. 1 (Amendment No. 1) to the Senior Credit Facility. Amendment No. 1 reduced the Company s interest rate by refinancing the existing Term Loan B (initially priced at LIBOR + 1.75% with a leverage-based pricing grid ranging from LIBOR + 1.50% to LIBOR + 1.75%) with a new Term Loan 1 having an applicable rate of LIBOR + 1.50% with no leverage-based pricing grid. If the Company makes any optional prepayments of its Term 1 Loans prior to the one-year anniversary of Amendment No. 1 in connection with any repricing transaction, the Company will be required to pay a prepayment premium of 1% of the amount of such Term 1 Loans being prepaid.

Amendment No. 1 also lowered the threshold for permitting restricted payments by raising the required leverage ratio (as defined) from 1.5 times to 2.5 times provided the Company has revolving loan commitments of $75.0 million available.

NOTE 7 EMPLOYEE BENEFIT PLANS:

Under a defined benefit plan, which was frozen in 1991, we offer a comprehensive post-retirement medical plan to current and certain future retirees and their spouses until they become eligible for Medicare or a Medicare supplement plan. We also offer life insurance to current and certain future retirees.

The components of post-retirement life and medical benefit expense charged to operations are as follows:

	For the three-month periods ended		For the nine-month periods ended	
(dollars in thousands)	**September 30, 2006**	**October 1, 2005**	**September 30, 2006**	**October 1, 2005**
Service cost benefits attributed to service during the period	$ 42	$ 25	$ 126	$ 75
Interest cost on accumulated post-retirement benefit obligation	160	171	477	504
Amortization of prior service cost	23		69	
Total net periodic pension benefit cost	$ 225	$ 196	$ 672	$ 579

We also have an obligation under a defined benefit plan covering certain former officers. The components of pension expense charged to operations related to this plan are as follows:

(dollars in thousands)	For the three-month periods ended September 30, 2006	October 1, 2005	For the nine-month periods ended September 30, 2006	October 1, 2005
Interest cost on accumulated pension benefit obligation	$ 19	$ 20	$ 57	$ 60

The Company maintains two defined benefit pension plans acquired in connection with the Acquisition. The benefits under these pension plans were frozen as of December 31, 2005, and cover certain current and former employees of OshKosh.

The Company s net periodic pension benefit related to these plans is comprised of the following components:

(dollars in thousands)	For the three-month periods ended September 30, 2006	October 1, 2005	For the nine-month periods ended September 30, 2006	October 1, 2005
Service cost	$ -	$ 56	$ -	$ 56
Interest cost	650	735	1,951	735
Expected return on assets	(1,035)	(926)	(3,104)	(926)
Net periodic pension benefit	$ (385)	$ (135)	$ (1,153)	$ (135)

See Note 7 Employee Benefit Plans to our consolidated financial statements in our most recently filed Annual Report on Form 10-K for further information.

NOTE 8 COMMON STOCK:

On May 12, 2006, the Company amended Article V of its certificate of incorporation. The amendment increased the number of authorized shares of the Company s common stock from 40,000,000 to 150,000,000.

On June 6, 2006, the Company effected a two-for-one stock split (the stock split) through a stock dividend to stockholders of record as of May 23, 2006, of one share of our common stock for each share of common stock outstanding. Earnings per share for all prior periods presented have been adjusted to reflect the stock split.

During the first nine months of fiscal 2006, we issued 17,172 shares of common stock to our non-management board members.

NOTE 9 STOCK-BASED COMPENSATION:

Under our Amended and Restated 2003 Equity Incentive Plan (the Plan), the compensation committee of our Board of Directors may award incentive stock options (ISOs and non-ISOs), stock appreciation rights (SARs), restricted stock, unrestricted stock, stock deliverable on a deferred basis, performance-based stock awards, and cash payments intended to help defray the cost of awards. All share and per share amounts have been adjusted to reflect the stock split discussed in Note 8 above.

On May 12, 2005, our Board of Directors implemented, and our stockholders approved an amendment to the Plan to increase the number of shares available to be delivered under the Plan by 2,800,000 to 11,488,392, with no more than 1,260,000 of such additional shares able to be used for awards other than stock options and to reduce the number of shares for which stock options may be granted to any individual or which can be subject to SARs granted to any individual in any calendar year from 8,000,000 to 2,000,000. As of September 30, 2006, there were 2,192,284 shares available for grant under the Plan. The Plan makes provision for the treatment of awards upon termination of service or in the case of a merger or similar corporate transaction. Participation in the Plan is limited to Directors and those key employees selected by the compensation committee. The limit on shares available under the Plan, the individual limits, and other award terms are subject to adjustment to reflect stock splits or stock dividends, combinations, and certain other events. All stock options issued under the Plan expire no later than ten years from the date of grant. The Company believes that the current level of authorized shares is sufficient to satisfy future option exercises.

There are currently three types of stock options outstanding under the Plan: basic, performance, and retained options. Basic options issued prior to May 12, 2005 vest in equal annual installments over a five-year period. Basic options granted on and subsequently to May 12, 2005 vest in equal annual installments over a four-year period. Performance options vest upon the achievement of pre-determined performance criteria. Retained stock options are options that were outstanding prior to the Company s 2001 acquisition by Berkshire Partners LLC and became fully vested in connection with the 2001 acquisition.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaced SFAS 123, Accounting for Stock-Based Compensation (SFAS 123) as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148), and supercedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). SFAS 123R requires companies to expense the fair value of employee stock options and similar awards. Effective January 1, 2006, the Company adopted SFAS 123R and began recognizing compensation expense for its share-based payments based on the fair value of the awards at the grant date. Under SFAS 123R, the pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition.

The Company adopted SFAS 123R using the modified prospective application method of transition. Therefore, prior period financial statements have not been restated. Under the modified prospective application method, for awards granted prior to January 1, 2006, compensation expense is recorded as options vest subsequent to January 1, 2006 based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, adjusted for estimated forfeitures. For stock options granted subsequent to January 1, 2006, compensation expense will be recorded as options vest based upon the grant-date fair value estimated in accordance with SFAS 123R, with forfeitures estimated at the time of grant. Forfeiture estimates will be adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from previous estimates.

The fair value of stock options under SFAS 123R is determined using the Black-Scholes option pricing model, which is consistent with our valuation techniques previously utilized for stock options in pro forma footnote disclosure required under SFAS 123. Prior to the filing of our first Registration Statement on Form S-1 on August 23, 2002 in connection with our initial public offering, we used the minimum value method to value stock options, as provided by SFAS 123, as amended by SFAS 148. Under SFAS 123R, no compensation expense has been recorded for options recorded under the minimum value method.

The fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant, consistent with our treatment of such awards under APB 25 prior to the adoption of SFAS 123R.

In connection with the adoption and provisions of SFAS 123R, the Company reversed its deferred compensation balance of $2,749,000 on January 1, 2006 related to restricted stock awards.

The adoption of SFAS 123R has resulted in additional pre-tax, share-based compensation expense (a component of selling, general, and administrative expenses) in the amount of approximately $984,000 and $2.9 million related to stock options for the three and nine-month periods ended September 30, 2006, than if the Company had continued to account for share-based compensation under APB 25. The impact on net income for the three-month period ended September 30, 2006 was a reduction of approximately $612,000, or $0.01, on both basic and diluted earnings per share. The impact on net income for the nine-month period ended September 30, 2006 was a reduction of approximately $1.8 million, or $0.03, on both basic and diluted earnings per share. For the fiscal year ended December 30, 2006, the adoption of SFAS 123R is expected to result in a reduction in net income of approximately $2.4 million, or $0.04 per basic and diluted earnings per share.

Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of EITF Issue No. 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. SFAS 123R requires the benefit of tax deductions in excess of the compensation cost recognized for exercised options and restricted stock that vests to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is now shown as Income tax benefit from exercised stock options on the accompanying unaudited condensed consolidated statement of cash flows. The income tax benefit from exercised stock options during the nine-month period ended September 30, 2006 was approximately $2.5 million. Prior periods have not been restated.

Prior to the adoption of SFAS 123R, we accounted for stock-based compensation on stock options under the intrinsic value method consistent with APB 25. Under this method, we recorded compensation expense equal to the difference between the exercise price of the stock option and the fair market value of the underlying stock as of the date of the option grant. Forfeitures on stock option awards with expense recorded in accordance with APB 25 were accounted for as they occurred, rather than based on estimates of future forfeitures. There was no material impact or cumulative effect adjustment required as a result of estimating the impact of future forfeitures on awards previously expensed in accordance with APB 25. For disclosure purposes only, we also estimated the impact on our net income of applying the fair value method of measuring compensation cost on stock options with the fair value of the Company s common stock. In our pro forma disclosure we accounted for forfeitures as they occurred, rather than based on estimates of future forfeitures.

The following table provides supplemental information for the three and nine-month periods ended October 1, 2005 as if stock-based compensation had been computed under SFAS 123, as amended by SFAS 148:

(dollars in thousands, except per share data)	**For the three-month period ended October 1, 2005**	**For the nine-month period ended October 1, 2005**
Net income, as reported	$ 10,578	$ 29,877
Add:		
Stock-based employee compensation (under APB 25) included in reported net income, net of related tax effects	278	755
Deduct:		
Total stock-based employee compensation expense determined under the fair value based method (under SFAS 123 and SFAS 148) for all awards, net of related tax effects	(669)	(1,850)
Pro forma net income	$ 10,187	$ 28,782
Net income per common share:		
Basic-as reported	$ 0.18	$ 0.52
Basic-pro forma	$ 0.18	$ 0.50
Diluted-as reported	$ 0.17	$ 0.49
Diluted-pro forma	$ 0.17	$ 0.47

A summary of stock option activity under the Plan (in number of shares that may be purchased) is as follows for the nine-month period ended September 30, 2006:

Basic Stock Options

	Basic stock options	**Weighted-average exercise price per share**	**Weighted-average grant-date fair value**
Outstanding, December 31, 2005	4,844,128	$ 6.23	$ 2.76
Granted	184,600	$ 33.73	$ 15.34
Exercised	(252,288)	$ 4.31	$ 2.09
Forfeited	(17,000)	$ 31.43	$ 12.66
Expired		*$*	*$*
Outstanding, September 30, 2006	4,759,440	$ 7.30	$ 3.25
Exercisable, September 30, 2006	3,728,300	$ 4.21	$ 1.86

During the nine months ended September 30, 2006, the Company granted 184,600 basic stock options. In connection with this grant of basic stock options, the Company recognized approximately $350,000 in compensation expense during the nine-month period ended September 30, 2006.

A summary of basic stock options outstanding and exercisable at September 30, 2006 is as follows:

	Outstanding				**Exercisable**			
Range of exercise prices	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**
$ 3 -$ 5	3,373,128	5.02 years	$ 3.14	$ 1.29	3,299,688	4.99 years	$ 3.11	$ 1.29
$ 6 -$ 7	317,392	6.96 years	$ 6.98	$ 4.88	159,632	6.96 years	$ 6.98	$ 4.88
$13 -$17	619,920	7.60 years	$ 14.88	$ 6.71	228,480	7.58 years	$ 14.81	$ 6.66
$22 -$27	240,000	8.80 years	$ 23.82	$ 9.52	35,000	8.63 years	$ 22.10	$ 8.75
$31 -$35	209,000	9.36 years	$ 33.47	$ 15.03	5,500	8.83 years	$ 31.43	$ 12.66
	4,759,440	5.87 years	$ 7.30	$ 3.25	3,728,300	5.28 years	$ 4.21	$ 1.86

At September 30, 2006, the aggregate intrinsic value of all outstanding basic options was approximately $92.3 million and the aggregate intrinsic value of currently exercisable basic options was approximately $82.7 million. The intrinsic value of basic options exercised during the three and nine-month periods ended September 30, 2006 was approximately $277,000 and $7.0 million. At September 30, 2006, the total estimated compensation cost related to non-vested basic options not yet recognized was approximately $6.8 million with a weighted-average expense recognition period of 2.83 years.

Performance Stock Options

	Performance stock options	**Weighted-average exercise price per share**	**Weighted-average grant-date fair value**
Outstanding, December 31, 2005	600,000	$ 25.06	$ 9.40
Granted	20,000	$ 24.20	$ 11.19
Exercised		$	$
Forfeited		$	$
Expired		$	$
Outstanding, September 30, 2006	620,000	$ 25.04	$ 9.46
Exercisable, September 30, 2006		*$*	*$*

During the three and nine months ended September 30, 2006, the Company granted 20,000 performance stock options. In connection with this grant of performance stock options, the Company recognized approximately $2,900 in compensation expense during the three and nine-month periods ended September 30, 2006.

A summary of performance stock options outstanding and exercisable at September 30, 2006 is as follows:

	Outstanding				**Exercisable**			
Range of exercise prices	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**
$22-$32	620,000	8.82 years	$ 25.04	$ 9.46			$	$

At September 30, 2006, the aggregate intrinsic value of all outstanding performance options was approximately $1.8 million. No performance options are currently exercisable. At September 30, 2006, the total estimated compensation cost related to non-vested performance options not yet recognized was approximately $4.2 million with a weighted-average expense recognition period of 2.90 years.

16

Retained Stock Options

	Retained stock options	Weighted-average exercise price per share
Outstanding, December 31, 2005	1,708,270	$ 0.75
Granted		$
Exercised		$
Forfeited		$
Expired		$
Outstanding, September 30, 2006	1,708,270	$ 0.75
Exercisable, September 30, 2006	1,708,270	$ 0.75

The weighted-average contractual life of the 1,708,270 retained stock options outstanding and exercisable as of September 30, 2006 is 4.88 years. At September 30, 2006, the aggregate intrinsic value of all outstanding retained options, which are all currently exercisable, was approximately $43.8 million.

The weighted-average contractual life for the basic, performance, and retained stock options in aggregate as of September 30, 2006 was approximately 5.89 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing method with the following weighted-average assumptions used for grants issued during the nine-month period ended September 30, 2006:

	For the nine-month period ended September 30, 2006	
Volatility	38.97	%
Risk-free interest rate	4.70	%
Expected term (years)	6.0	
Dividend yield		

Volatility This is a measure of the amount by which a stock price has fluctuated or is expected to fluctuate. The Company uses actual monthly historical changes in the market value of our stock since the Company s initial public offering on October 29, 2003, supplemented by peer company data for periods prior to our initial public offering covering the expected life of options being valued. An increase in the expected volatility will increase compensation expense.

Risk-free interest rate This is the U.S. Treasury rate as of the grant date having a term equal to the expected term of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected term This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience and estimated future exercise behavior. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. An increase in the expected term will increase compensation expense.

Dividend yield The Company does not have plans to pay dividends in the foreseeable future. An increase in the dividend yield will decrease compensation expense.

Restricted Stock

All restricted stock awards issued under the Plan vest based upon continued service. Restricted stock awards vest in equal annual installments over a four-year period or cliff vest after a three or four-year period. As noted above, the fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant.

The following table summarizes our restricted stock award activity during the nine-month period ended September 30, 2006:

	Restricted stock
Outstanding, December 31, 2005	134,270
Granted	100,200
Vested	(4,750)
Forfeited	(8,000)
Outstanding, September 30, 2006	221,720

During the three-month period ended September 30, 2006, the Company granted 10,000 shares of restricted stock to an employee. In connection with this issuance, we recorded approximately $3,300 of compensation expense.

During the nine-month period ended September 30, 2006, the Company granted 100,200 shares of restricted stock to employees.   Compensation expense recorded during the nine-month period ended September 30, 2006 for all restricted stock awards totaled approximately $987,000. The total amount of estimated compensation expense related to unvested restricted stock awards is approximately $4.6 million as of September 30, 2006.

Unrecognized stock-based compensation expense related to outstanding stock options and restricted stock awards is expected to be recorded as follows:

(dollars in thousands)	**Basic options**	**Performance options**	**Restricted stock**	**Total**
2006 (period from October 1 through December 30)	$ 626	$ 378	$ 389	$ 1,393
2007	2,496	1,516	1,554	5,566
2008	2,383	1,516	1,526	5,425
2009	1,218	740	1,059	3,017
2010	103	90	115	308
Total	$ 6,826	$ 4,240	$ 4,643	$ 15,709

NOTE 10 SEGMENT INFORMATION:

We report segment information in accordance with the provisions of SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, which requires segment information to be disclosed based upon a management approach. The management approach refers to the internal reporting that is used by management for making operating decisions and assessing the performance of our operating segments.

The table below presents certain segment information for the periods indicated:

	For the three-month periods ended				For the nine-month periods ended			
	September 30, 2006	% of Total	October 1, 2005 (a)	% of Total	September 30, 2006	% of Total	October 1, 2005 (a)	% of Total
Net sales:								
Wholesale-Carter s	$ 143,624	36.6 %	$ 130,757	35.1 %	$ 330,080	34.2 %	$ 315,757	41.0 %
Wholesale-OshKosh	25,778	6.6 %	32,644	8.8 %	74,870	7.8 %	32,644	4.2 %
Retail-Carter s	93,493	23.9 %	87,664	23.5 %	233,956	24.2 %	222,925	28.9 %
Retail-OshKosh	62,739	16.0 %	63,500	17.1 %	155,754	16.1 %	63,500	8.2 %
Mass Channel-Carter s	66,343	16.9 %	57,593	15.5 %	171,341	17.7 %	136,039	17.7 %
Total net sales	$ 391,977	100.0 %	$ 372,158	100.0 %	$ 966,001	100.0 %	$ 770,865	100.0 %

		% of net sales		% of net sales		% of net sales		% of net sales
Operating income:								
Wholesale-Carter s	$ 32,750	22.8 %	$ 28,093	21.5 %	$ 66,170	20.0 %	$ 61,070	19.3 %
Wholesale-OshKosh	3,806	14.8 %	1,231 (b)	3.8 %	8,396	11.2 %	1,231 (b)	3.8 %
Retail-Carter s	17,435	18.6 %	20,941	23.9 %	37,780	16.1 %	43,589	19.6 %
Retail-OshKosh	7,444	11.9 %	949 (c)	1.5 %	10,276	6.6 %	949 (c)	1.5 %
Mass Channel-Carter s	10,746	16.2 %	7,302	12.7 %	24,644	14.4 %	14,117	10.4 %
Mass Channel-OshKosh (d)	604		63		1,440		63	
Segment operating Income	72,785	18.6 %	58,579	15.7 %	148,706	15.4 %	121,019	15.7 %
Other reconciling items	(11,279)	(2.9)%	(13,522)(e)	(3.6)%	(33,512)	(3.5)%	(35,604)(e)	(4.6)%
Total operating Income	$ 61,506	15.7 %	$ 45,057	12.1 %	$ 115,194	11.9 %	$ 85,415	11.1 %

(a) Financial results for the three and nine-month periods ended October 1, 2005 include the operations of OshKosh for the period from July 14, 2005 through October 1, 2005.

(b) The three and nine-month periods ended October 1, 2005 include a charge of $3.3 million related to the amortization of a fair value step-up for wholesale inventory acquired from OshKosh.

(c) The three and nine-month periods ended October 1, 2005 include a charge of $7.1 million related to the amortization of a fair value step-up for retail store inventory acquired from OshKosh.

(d) OshKosh mass channel consists of a licensing agreement with Target Stores. Operating income consists of royalty income, net of related expenses.

(e) The three and nine-month periods ended October 1, 2005 include $1.5 million and $6.1 million, respectively, of charges related to the closure of the Company s sewing facilities in Mexico.

NOTE 11 RESTRUCTURING AND CLOSURE COSTS:

In connection with the Acquisition, management has developed a plan to restructure and integrate the operations of OshKosh. In accordance with EITF No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, liabilities have been established for OshKosh severance and relocation, lease termination costs associated with the closure of OshKosh s 15 Lifestyle stores and 14 outlet stores in fiscal 2005, one outlet store closure in fiscal 2006, contract termination costs, and other exit costs. These liabilities also cover costs related to the closure of the OshKosh Choloma, Honduras sewing facility, Uman, Mexico sewing facility, and Liberty, Kentucky distribution center. The Choloma, Honduras and Liberty, Kentucky facilities were closed during the fourth quarter of fiscal 2005. The Uman, Mexico facility was closed during the first quarter of fiscal 2006. We expect to pay these liabilities during fiscal 2006 and the first half of fiscal 2007.

The following table summarizes restructuring activity related to the Acquisition:

(dollars in thousands)	Severance and relocation	Other exit costs	Lease termination costs	Contract termination costs	Total
Balance at July 14, 2005	$ 9,840	$ 2,075	$ 7,020	$ 2,000	$ 20,935
Payments	(2,304)	(71)	(468)	(934)	(3,777)
Adjustments to cost in excess of fair value of net assets acquired	673	(78)		(168)	427
Balance at December 31, 2005	8,209	1,926	6,552	898	17,585
Payments	(4,687)	(1,349)	(4,068)	(399)	(10,503)
Adjustments to cost in excess of fair value of net assets acquired	(780)	170	180	(299)	(729)
Balance at September 30, 2006	$ 2,742	$ 747	$ 2,664	$ 200	$ 6,353

In May 2005, we decided to exit two sewing facilities in Mexico. The total number of employees initially terminated was approximately 1,124. Production at these facilities ceased on August 5, 2005. As a result of these closures, in fiscal 2005, we recorded total charges of $8.4 million, including $4.6 million of severance charges, $1.3 million of lease termination charges, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.8 million of other exit costs. During the first nine months of fiscal 2005, we recorded total charges of $7.6 million, including $4.2 million of severance charges, $1.3 million of lease termination costs, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.4 million of other exit costs. During the first nine months of fiscal 2006, we recorded total charges of $91,000, including $74,000 of severance charges and $17,000 of other exit costs.

Restructuring provisions recorded as a result of these closures are as follows and are included in other current liabilities on the accompanying unaudited condensed consolidated balance sheet:

(dollars in thousands)	December 31, 2005 reserves	Provisions	Payments	September 30, 2006 reserves
Severance and other termination benefits	$ 370	$ 74	$ (266)	$ 178
Lease termination costs	813		(752)	61
Other exit costs	150	17	(167)	
Total	$ 1,333	$ 91	$ (1,185)	$ 239

NOTE 12 EARNINGS PER SHARE:

In accordance with SFAS No. 128, Earnings Per Share, basic earnings per share is based on the weighted-average number of common shares outstanding during the year, whereas diluted earnings per share also gives effect to all potentially dilutive shares of common stock, including basic and retained stock options and unvested restricted stock, that were outstanding during the period. Share and per share amounts for prior periods have been adjusted to reflect the stock split described in Note 8. All such stock options are reflected in the denominator using the treasury stock method. This method assumes that shares are issued for stock options that are in the money, but that we use the proceeds of such stock option exercises (generally, cash to be paid plus future compensation expense to be recognized and the amount of tax benefits, if any, that will be credited to additional paid-in capital assuming exercise of the stock options) to repurchase shares at the average market value of Carter s, Inc. s stock for the respective periods. Unvested shares of restricted stock are reflected in the denominator using the treasury stock method with proceeds of the amount, if any, the employees must pay upon vesting, the amount of compensation cost attributed to future services and not yet recognized in earnings, and the amount of tax benefits, if any, that would be credited to additional paid-in capital (i.e., the amount of the tax deduction in excess of recognized compensation cost) assuming vesting of the shares at the current market price.

For the three and nine-month periods ended September 30, 2006, anti-dilutive shares of 545,950 and 315,750, respectively, and performance-based options of 620,000, were excluded from the computations of diluted earnings per share. For the three and nine-month periods ended October 1, 2005, anti-dilutive shares of 56,000 and 148,000 respectively, and performance based options of 400,000, were excluded from the computation of diluted earnings per share.

The following is a reconciliation of basic common shares outstanding to diluted common and common equivalent shares outstanding:

	For the three-month periods ended		**For the nine-month periods ended**	
	September 30, 2006	**October 1, 2005**	**September 30, 2006**	**October 1, 2005**
Net income	$ 34,977,000	$ 10,578,000	$ 59,781,000	$ 29,877,000
Weighted-average number of common and common equivalent shares outstanding:				
Basic number of common shares outstanding	57,949,783	57,439,850	57,845,521	57,177,740
Diluted effect of unvested restricted stock	35,400	20,554	65,310	1,868
Dilutive effect of stock options	3,108,958	3,471,652	3,262,416	3,493,012
Diluted number of common and common equivalent shares outstanding	61,094,141	60,932,056	61,173,247	60,672,620
Basic net income per common share	$ 0.60	$ 0.18	$ 1.03	$ 0.52
Diluted net income per common share	$ 0.57	$ 0.17	$ 0.98	$ 0.49

21

NOTE 13 RECENT ACCOUNTING PRONOUNCEMENTS:

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The evaluation of a tax position in accordance with this interpretation begins with a determination as to whether it is more likely than not that a tax position will be sustained upon examination based on the technical merits of the position. A tax position that meets the more-likely-than-not recognition threshold is then measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement for recognition in the financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is assessing FIN 48 and has not determined the impact, if any, of the adoption of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective as of the beginning of our 2008 fiscal year. We are currently evaluating the impact of adopting SFAS 157 on our financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132 (R) (SFAS 158). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The provisions of SFAS 158 are effective for the Company as of December 30, 2006, except for the measurement date provisions, which are effective for the Company beginning December 31, 2006. Based on the Company s previously reported unfunded obligation as of December 31, 2005, the adoption of SFAS 158 would reduce total stockholders equity by approximately $1.4 million. The adoption of SFAS 158 will not affect our results of operations. By the time of the adoption at December 31, 2006, plan performance and actuarial assumptions could have a significant impact on the actual amounts recorded. The Company does not believe the adoption of SFAS 158 will have an impact on the Company s financial covenants.

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

The following is a discussion of our results of operations and current financial position. You should read this discussion in conjunction with our unaudited condensed consolidated financial statements and notes included elsewhere in this quarterly report.

Our fiscal year ends on the Saturday in December or January nearest to the last day of December. The accompanying unaudited condensed consolidated financial statements for the third quarter and first nine months of fiscal 2006 reflect our financial position as of September 30, 2006. The third quarter and first nine months of fiscal 2005 ended on October 1, 2005.

On July 14, 2005, Carter s, Inc., through its wholly-owned subsidiary, The William Carter Company, acquired all of the outstanding common stock of OshKosh B Gosh, Inc. (the Acquisition). Results of operations for the three and nine-month periods ended September 30, 2006 include the operations of OshKosh for the entire period. Results for the three and nine-month periods ended October 1, 2005 include the operations of OshKosh for the period from July 14, 2005 through October 1, 2005.

As part of financing the Acquisition, we refinanced our existing debt (the Refinancing), including our former senior credit facility and repurchased our outstanding 10.875% Senior Subordinated Notes due 2011 (together with the Acquisition, the Transaction). Financing for the Transaction was provided by a new $500 million Term Loan 1 and a $125 million revolving credit facility (including a sub-limit for letters of credit of $80 million, the Revolver) (altogether, the Senior Credit Facility). Subsequent to the Refinancing, we repaid $107.1 million under our Term Loan 1 resulting in a balance of $392.9 million at September 30, 2006.

As a result of the Refinancing, we experienced a significant increase in interest costs with weighted-average borrowings of $408.8 million at an effective interest rate of 6.3% for the nine-month period ended September 30, 2006 as compared to weighted-average borrowings of $313.9 million at an effective interest rate of 7.4% for the nine-month period ended October 1, 2005. Additionally, we acquired certain indefinite-lived intangible assets in connection with the Acquisition. Such assets include licensing agreements and leasehold interests, which will result in annual amortization expense of $4.7 million in fiscal 2006, $4.4 million in fiscal 2007, $4.1 million in fiscal 2008, $3.7 million in fiscal 2009, and $1.8 million in fiscal 2010.

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which is estimated to result in a reduction in fiscal 2006 net income of approximately $2.4 million, or approximately $0.04 per diluted share. The impact of adopting SFAS 123R is discussed further in Note 9 to the accompanying unaudited condensed consolidated financial statements.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, (i) selected statement of operations data expressed as a percentage of net sales and (ii) the number of retail stores open at the end of each period:

	Three-month periods ended		Nine-month periods ended	
	September 30, 2006	October 1, 2005	September 30, 2006	October 1, 2005
Wholesale sales:				
Carter s	36.6 %	35.1 %	34.2 %	41.0 %
OshKosh	6.6	8.8	7.8	4.2
Total wholesale sales	43.2	43.9	42.0	45.2
Retail store sales:				
Carter s	23.9	23.5	24.2	28.9
OshKosh	16.0	17.1	16.1	8.2
Total retail store sales	39.9	40.6	40.3	37.1
Mass channel sales	16.9	15.5	17.7	17.7
Consolidated net sales	100.0	100.0	100.0	100.0
Cost of goods sold	62.4	65.4	63.5	64.9
Gross profit	37.6	34.6	36.5	35.1
Selling, general, and administrative expenses	23.9	24.0	26.8	25.0
Closure costs		0.4		0.8
Royalty income	(2.0)	(1.9)	(2.2)	(1.8)
Operating income	15.7	12.1	11.9	11.1
Loss on extinguishment of debt		5.4		2.6
Interest expense, net	1.7	2.0	2.1	2.1
Income before income taxes	14.0	4.7	9.8	6.4
Provision for income taxes	5.1	1.9	3.6	2.5
Net income	8.9 %	2.8 %	6.2 %	3.9 %
Number of retail stores at end of period:				
Carter s	205	186	205	186
OshKosh	146	152	146	152
Total	351	338	351	338

Three and nine-month periods ended September 30, 2006 compared to the three and nine-month periods ended October 1, 2005

CONSOLIDATED NET SALES

In the third quarter of fiscal 2006, consolidated net sales increased $19.8 million, or 5.3%, to $392.0 million. This increase reflects growth in all of our *Carter s* brand distribution channels. In the first nine months of fiscal 2006, consolidated net sales increased $195.1 million, or 25.3%, to $966.0 million. This increase reflects the benefit of *OshKosh* brand sales for the entire period in fiscal 2006 and growth in all of our *Carter s* brand distribution channels.

	For the three-month periods ended				**For the nine-month periods ended**			
(dollars in thousands)	**Sept 30, 2006**	**% of Total**	**Oct 1, 2005**	**% of Total**	**Sept 30, 2006**	**% of Total**	**Oct 1, 2005**	**% of Total**
Net sales:								
Wholesale-Carter s	$ 143,624	36.6 %	$ 130,757	35.1 %	$ 330,080	34.2 %	$ 315,757	41.0 %
Wholesale-OshKosh	25,778	6.6 %	32,644	8.8 %	74,870	7.8 %	32,644	4.2 %
Retail-Carter s	93,493	23.9 %	87,664	23.5 %	233,956	24.2 %	222,925	28.9 %
Retail-OshKosh	62,739	16.0 %	63,500	17.1 %	155,754	16.1 %	63,500	8.2 %
Mass Channel-Carter s	66,343	16.9 %	57,593	15.5 %	171,341	17.7 %	136,039	17.7 %
Total net sales	$ 391,977	100.0 %	$ 372,158	100.0 %	$ 966,001	100.0 %	$ 770,865	100.0 %

CARTER S WHOLESALE SALES

Carter s brand wholesale sales increased 9.8% in the third quarter of fiscal 2006 to $143.6 million. Excluding off-price sales, *Carter s* brand wholesale sales increased $10.8 million in the third quarter of fiscal 2006, or 8.7%, to $134.6 million. This increase in *Carter s* brand wholesale sales, excluding off-price sales, was driven by a 10% increase in units shipped offset by a 1% decrease in average price per unit as compared to the third quarter of fiscal 2005. The increase in units shipped during the third quarter of fiscal 2006 was driven by growth in all of our product categories. The decrease in average price per unit as compared to the third quarter of fiscal 2005 was driven primarily by lower average playwear price per unit.

Carter s brand wholesale sales increased $14.3 million, or 4.5%, in the first nine months of fiscal 2006 to $330.1 million. Excluding off-price sales, *Carter s* brand wholesale sales increased $17.0 million in the first nine months of fiscal 2006, or 5.8%, to $307.3 million. The increase in *Carter s* brand wholesale sales during the first nine months of fiscal 2006, excluding off-price sales, was driven by an 8% increase in units shipped offset by a 2% decrease in average price per unit. The increase in units shipped was driven by growth in our baby and playwear product categories. The decrease in average price per unit as compared to the first nine months of fiscal 2005 was driven primarily by lower average playwear and sleepwear price per unit.

Off-price sales increased $2.1 million in the third quarter of fiscal 2006, or 30.4%, to $9.0 million due to a 2% increase in units shipped and a 28% increase in average prices. Off-price sales decreased $2.6 million in the first nine months of fiscal 2006, or 10.3%, to $22.8 million, due to an 11% decrease in units shipped offset by a 1% increase in average price per unit compared to the first nine months of fiscal 2005. The decrease in units shipped in the first nine months of fiscal 2006 resulted from lower levels of excess inventory available to be sold and average prices fluctuated due to the mix of available excess inventory.

OSHKOSH WHOLESALE SALES

Since the Acquisition, we have reduced the number of *OshKosh* wholesale brands from three brands to one brand-*OshKosh B Gosh*, significantly reduced the number of styles in order to improve productivity, exited unprofitable and marginally profitable customer relationships, and began working with our key customers to build plans for growth.

Results for the third quarter and first nine months of fiscal 2005 include wholesale sales from the Acquisition date of July 14, 2005 through October 1, 2005 and, therefore, are not comparable to the third quarter and first nine months of fiscal 2006. *OshKosh* brand wholesale sales were $25.8 million for the third quarter of fiscal 2006 and $32.6 million for the period from July 14, 2005 through October 1, 2005. Excluding off-price sales, *OshKosh* brand wholesale sales were $24.8 million in the third quarter of fiscal 2006 and $28.6 million for the period from July 14, 2005 through October 1, 2005. *OshKosh* brand wholesale sales were $74.9 million for the first nine months of fiscal 2006 and excluding off-price sales, *OshKosh* brand wholesale sales were $69.0 million in the first nine months of fiscal 2006.

MASS CHANNEL SALES

Mass channel sales increased $8.8 million in the third quarter of fiscal 2006, or 15.2%, to $66.3 million. The increase was driven by increased sales of $5.7 million, or 15.5%, of our *Child of Mine* brand to Wal-Mart and increased sales of $3.0 million, or 14.7%, of our *Just One Year* brand to Target. The growth in third quarter sales was driven by increased productivity and new door growth.

Mass channel sales increased $35.3 million in the first nine months of fiscal 2006, or 25.9%, to $171.3 million. The increase was driven by increased sales of $23.6 million, or 27.6%, of our *Child of Mine* brand to Wal-Mart and increased sales of $11.7 million, or 23.2%, of our *Just One Year* brand to Target. The growth in sales for the first nine months of fiscal 2006 resulted from increased productivity, additional floor space in existing stores, and new door growth.

CARTER S BRAND RETAIL STORES

Carter s brand retail store sales increased $5.8 million in the third quarter of fiscal 2006, or 6.6%, to $93.5 million. The increase was driven by incremental sales of $6.5 million generated by new store openings and a comparable store sales increase of $1.5 million, or 1.7%, based on 177 locations, partially offset by the impact of store closures of $2.2 million. On a comparable store basis, transactions increased 4.1% and units per transaction were flat, as compared to the third quarter of fiscal 2005. The increase in transactions was driven by increased promotional activity on fall playwear during the third quarter of fiscal 2006 which led to a decrease in average prices of 2.5%.

Carter s brand retail store sales increased $11.0 million in the first nine months of fiscal 2006, or 4.9%, to $234.0 million. The increase was driven by incremental sales of $15.2 million generated by new store openings and a comparable store sales increase of $1.2 million, or 0.6%, based on 177 locations, partially offset by the impact of store closures of $5.4 million. On a comparable store basis, transactions increased 1.2% and units per transactions were flat, as compared to the first nine months of fiscal 2005. Average prices during the first nine months decreased 1.0% as compared to the first nine months of fiscal 2005.

The Company s comparable store sales calculations include sales for all stores that were open during the comparable fiscal period, including remodeled stores and certain relocated stores. If a store relocates within the same center with no business interruption or material change in square footage, the sales for such store will continue to be included in the comparable store calculation. If a store relocates to another center or there is a material change in square footage, such store is treated as a new store. Stores that are closed are included in the comparable store sales calculation up to the date of closing.

There were a total of 205 *Carter s* brand retail stores as of September 30, 2006. During the third quarter of fiscal 2006, we opened five stores. During the first nine months of fiscal 2006, we opened 16 stores and closed four stores. We plan to open 30 and close eight *Carter s* brand retail stores during fiscal 2006.

OSHKOSH BRAND RETAIL STORES

OshKosh brand retail store sales were $62.7 million for the third quarter of fiscal 2006 and $63.5 million for the period from July 14, 2005 through October 1, 2005. *OshKosh* brand retail stores were $155.8 million for the first nine months of fiscal 2006 and $63.5 million for the first nine months of fiscal 2005. Results for the third quarter and first nine months of fiscal 2005 include *OshKosh* brand retail store sales from the Acquisition date of July 14, 2005 through October 1, 2005 and therefore, are not comparable to the third quarter and first nine months of fiscal 2006.

There were a total of 146 *OshKosh* brand retail stores as of September 30, 2006. During the third quarter of fiscal 2006, we opened four stores and closed one. During the first nine months of fiscal 2006, we opened six stores and closed two stores. We plan to open 15 and close three *OshKosh* brand retail stores during fiscal 2006.

GROSS PROFIT

Our gross profit increased $18.6 million, or 14.4%, to $147.2 million in the third quarter of fiscal 2006. Gross profit as a percentage of net sales was 37.6% in the third quarter of fiscal 2006 as compared to 34.6% in the third quarter of fiscal 2005.

The increase in gross profit as a percentage of net sales during the third quarter of 2006 reflects:

(i) an amortization charge of $10.4 million related to a fair value step-up of inventory acquired from OshKosh recorded in the third quarter of fiscal 2005; and

(ii) accelerated depreciation of $0.6 million recorded in the third quarter of fiscal 2005 in connection with the closure of two *Carter s* sewing facilities in Mexico.

Partially offsetting this increase was:

(i) growth in our lower margin mass channel business, sales of which increased 15.2% in the third quarter of fiscal 2006; and

(ii) a decrease in consolidated retail store gross margin from 52.4% in the third quarter of fiscal 2005 to 51.6% in the third quarter of fiscal 2006.

27

Our gross profit increased $82.1 million, or 30.4%, to $352.6 million in the first nine months of fiscal 2006. Gross profit as a percentage of net sales was 36.5% in the first nine months of fiscal 2006 as compared to 35.1% in the first nine months of fiscal 2005.

The increase in gross profit as a percentage of net sales during the first nine months of fiscal 2006 reflects:

(i) the $10.4 million inventory step-up amortization charge in fiscal 2005 noted above;

(ii) significant growth in our higher margin retail business, resulting from the Acquisition of the *OshKosh* brand retail stores (consolidated retail sales increased from 37.1% of total sales in the first nine months of fiscal 2005 to 40.3% of total sales in the first nine months of fiscal 2006); and

(iii) accelerated depreciation of $1.6 million recorded in the first nine months of fiscal 2005 in connection with the closure of two *Carter s* sewing facilities in Mexico.

Partially offsetting this increase was:

(i) growth in our lower margin mass channel business, which was up 25.9% in the first nine months of fiscal 2006; and

(ii) the impact of lower margin *OshKosh* brand wholesale sales relative to *Carter s* brand wholesale sales.

The Company includes distribution costs in its selling, general, and administrative expenses. Accordingly, the Company s gross margin may not be comparable to other companies that include such distribution costs in their cost of goods sold.

SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES

Selling, general, and administrative expenses in the third quarter of fiscal 2006 increased $4.2 million, or 4.7%, to $93.5 million. As a percentage of net sales, selling, general, and administrative expenses in the third quarter of fiscal 2006 were 23.9% as compared to 24.0% in the third quarter of fiscal 2005.

The decline in selling, general, and administrative expenses as a percentage of net sales in the third quarter of fiscal 2006 was impacted primarily by:

(i) a decline in distribution costs as a percentage of sales from 3.9% in the third quarter of fiscal 2005 to 3.7% in the third quarter of fiscal 2006, driven primarily by efficiencies gained from increased leverage of fixed costs on higher unit volumes at our distribution centers in Georgia and changing our third-party logistics provider on the west coast, primarily for our mass channel customers; and

(ii) effectively managing the growth in spending to a rate lower than the growth in net sales.

Partially offsetting these declines were:

(i) growth in our retail store administration expenses from 2.8% of retail store net sales in the third quarter of fiscal 2005 to 4.1% of retail store net sales in the third quarter of fiscal 2006. This increase was driven by investing in our retail management team in order to support future growth initiatives; and

(ii) incremental stock-based compensation expense of approximately $1.0 million resulting from the adoption of SFAS 123R as further discussed in Note 9 to the accompanying unaudited condensed consolidated financial statements.

Selling, general, and administrative expenses in the first nine months of fiscal 2006 increased $66.4 million, or 34.5%, to $258.9 million. As a percentage of net sales, selling, general, and administrative expenses in the first nine months of fiscal 2006 were 26.8% as compared to 25.0% in the first nine months of fiscal 2005.

The increase in selling, general, and administrative expenses as a percentage of net sales in the first nine months of fiscal 2006 was impacted primarily by:

(i) retail store sales increasing to 40.3% of our consolidated sales mix from 37.1% last year due to the Acquisition of OshKosh. Our retail stores carry a higher selling, general, and administrative cost structure than other components of our business. This has resulted in our retail store selling, general, and administrative expenses increasing to 11.2% of consolidated net sales compared to 9.2% last year;

(ii) growth in our retail store administration expenses from 3.6% of retail store sales in the first nine months of fiscal 2005 to 4.5% in the first nine months of fiscal 2006;

(iii) incremental amortization of OshKosh intangible assets related to OshKosh licensing agreements and leasehold interests capitalized in connection with the Acquisition, ($3.5 million in the first nine months of fiscal 2006 as compared to $1.0 million in the first nine months of fiscal 2005); and

(iv) incremental stock-based compensation expense of $2.9 million resulting from the adoption of SFAS 123R as further discussed in Note 9 to the accompanying unaudited condensed consolidated financial statements.

Partially offsetting these increases were:

(i) a decline in distribution costs as a percentage of sales from 4.3% in the first nine months of fiscal 2005 to 4.1% in the first nine months of fiscal 2006, driven primarily by efficiencies gained from increased leverage of fixed costs on higher unit volumes at our distribution centers in Georgia and changing our third-party logistics provider on the west coast, primarily for our mass channel customers; and

(ii) effectively managing the growth in spending to a rate lower than the growth in net sales.

CLOSURE COSTS

In May 2005, we decided to exit two *Carter s* brand sewing facilities in Mexico. We have developed alternative capabilities to source comparable products in the Far East at lower costs. As a result of these closures, in fiscal 2005, we recorded costs of $8.4 million, including $4.6 million of severance charges, $1.3 million in lease termination costs, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.8 million of other exit costs.

As a result of these closures during the third quarter of fiscal 2005, we recorded total charges of $2.1 million, including $1.1 million of severance charges, $0.6 million of accelerated depreciation (included in cost of goods sold), and $0.4 million of other exit costs.

In the first nine months of fiscal 2005, we recorded total costs of $7.6 million, including $4.2 million of severance charges, $1.3 million of lease termination costs, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.4 million of other exit costs.

In the first nine months of fiscal 2006, in connection with these closures, we recorded costs of $91,000, including $74,000 of severance and $17,000 of other exit costs. We do not expect any additional charges associated with these closures.

ROYALTY INCOME

Our royalty income increased $0.6 million to $7.8 million in the third quarter of fiscal 2006 and increased $8.1 million to $21.6 million in the first nine months of fiscal 2006.

We license the use of our *Carter s*, *Carter s Classics*, *Just One Year*, and *Child of Mine* brands. Royalty income from these brands was approximately $4.2 million in the third quarter of fiscal 2006, which was relatively flat as compared to the third quarter of fiscal 2005.

Royalty income from our *Carter s*, *Carter s Classics*, *Just One Year,* and *Child of Mine* brands was approximately $11.3 million in the first nine months of fiscal 2006, an increase of 7.7%, or $0.8 million, as compared to the first nine months of fiscal 2005. This increase was driven primarily by increased sales by our *Carter s* and *Child of Mine* brand licensees.

We also license the use of our *OshKosh B Gosh* and *Genuine Kids from OshKosh* brands. Our *Genuine Kids from OshKosh* brand is sold exclusively by Target. Results for the third quarter and first nine months of fiscal 2005 include royalty income from the Acquisition date of July 14, 2005 through October 1, 2005, and therefore, are not comparable to the third quarter and first nine months of fiscal 2006. Royalty income from these brands was approximately $3.6 million during the third quarter of fiscal 2006, including $1.7 million from international royalty income, and $3.0 million during the period from July 14, 2005 through October 1, 2005, including $1.5 million from international royalty income. During the first nine months of fiscal 2006, royalty income from these brands was $10.3 million, including $5.2 million from international royalty income.

OPERATING INCOME

As a result of the factors described above, operating income increased $16.4 million, or 36.5%, to $61.5 million in the third quarter of fiscal 2006 and increased $29.8 million, or 34.9%, to $115.2 million in the first nine months of fiscal 2006.

LOSS ON EXTINGUISHMENT OF DEBT

As described in Note 3 to the accompanying unaudited condensed consolidated financial statements, in connection with the Acquisition and Refinancing, we incurred a $14.0 million redemption premium in connection with the repurchase of our 10.875% Senior Subordinated Notes, wrote off a $0.5 million debt discount on our 10.875% Senior Subordinated Notes, wrote off $4.5 million in debt issuance costs associated with our former senior credit facility and wrote off $1.1 million in new debt issuance costs associated with our new Senior Credit Facility in accordance with Emerging Issues Task Force No. 98-14, Debtor s Accounting for a Modification or Exchange of Debt Instruments.

INTEREST EXPENSE, NET

Interest expense in the third quarter of fiscal 2006 decreased $0.9 million, or 12.0%, to $6.6 million. Weighted-average borrowings in the third quarter of fiscal 2006 were $393.6 million at an effective interest rate of 6.4% as compared to weighted-average borrowings in the third quarter of fiscal 2005 of $489.6 million at an effective interest rate of 5.5%. During the three-month period ended September 30, 2006, we reclassified approximately $0.5 million related to our interest rate swap agreement (see Note 3 to the accompanying unaudited condensed consolidated financial statements) into earnings, which effectively reduced our interest expense under the Term Loan 1.

Interest expense in the first nine months of fiscal 2006 increased $4.5 million, or 28.1%, to $20.4 million. The increase is attributable to the impact of additional borrowings associated with the Acquisition and Refinancing. Weighted-average borrowings in the first nine months of fiscal 2006 were $408.8 million at an effective interest rate of 6.3% as compared to weighted-average borrowings in the first nine months of fiscal 2005 of $313.9 million at an effective interest rate of 7.4%. During the nine-month period ended September 30, 2006, we reclassified approximately $0.9 million related to our interest rate swap agreement into earnings, which effectively reduced our interest expense under the Term Loan 1.

INCOME TAXES

Our effective tax rate was 36.3% for the third quarter of fiscal 2006 and 37.0% for the first nine months of fiscal 2006. The effective tax rate for the third quarter and first nine months of fiscal 2005 was 39.5%. The decrease in the effective tax rate was due primarily to lower state taxable income.

NET INCOME

As a result of the factors noted above, our third quarter fiscal 2006 net income increased to approximately $35.0 million compared to approximately $10.6 million in the third quarter of fiscal 2005. Our net income for the first nine months of fiscal 2006 increased to approximately $59.8 million as compared to approximately $29.9 million in the first nine months of fiscal 2005.

FINANCIAL CONDITION, CAPITAL RESOURCES, AND LIQUIDITY

Our primary cash needs are working capital, capital expenditures, and debt service. Our primary source of liquidity will continue to be cash flow from operations and borrowings under our Revolver, and we expect that these sources will fund our ongoing requirements for working capital, debt service, and capital expenditures. These sources of liquidity may be impacted by continued demand for our products and our ability to meet debt covenants under our Senior Credit Facility.

Net accounts receivable at September 30, 2006 were $150.8 million compared to $132.7 million at October 1, 2005 and $96.1 million at December 31, 2005. The increase as compared to October 1, 2005 reflects higher level of sales in the latter part of the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005. Due to the seasonal nature of our operations, the net accounts receivable balance at September 30, 2006 is not comparable to the net accounts receivable balance at December 31, 2005.

Net inventories at September 30, 2006 were $199.8 million compared to $209.9 million at October 1, 2005 and $188.5 million at December 31, 2005. This decrease as compared to October 1, 2005 is due primarily to carrying lower average inventory levels in our retail stores as compared to October 1, 2005, and exiting of OshKosh s off-shore sewing facilities at the end of fiscal 2005 and the first quarter of fiscal 2006. Due to the seasonal nature of our operations, net inventories at September 30, 2006 are not comparable to net inventories at December 31, 2005.

Net cash used in operating activities for the first nine months of fiscal 2006 was $5.2 million compared to net cash provided by operating activities of $34.2 million in the first nine months of fiscal 2005. The change in net cash used in operating activities in the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005 was driven by increases in accounts receivable due to the timing of shipments and reductions in accounts payable and other current liabilities.

We invested $15.9 million in capital expenditures during the first nine months of fiscal 2006 compared to $10.7 million during the first nine months of fiscal 2005. We plan to invest an additional $21 million in capital expenditures during the remainder of fiscal 2006. Major investments will include retail store openings and remodelings and investments in information technology.

In connection with the Acquisition, we developed an integration plan that includes costs related to severance and relocation, facility and store closings, and contract terminations. The following liabilities, included in other current liabilities in the accompanying unaudited condensed consolidated financial statements, were established at the closing of the Acquisition and will be funded by cash flows from operations and borrowings under our Revolver:

(dollars in thousands)	**Severance and relocation costs**	**Other exit costs**	**Lease termination costs**	**Contract termination costs**	**Total**
Balance at December 31, 2005	$ 8,209	$ 1,926	$ 6,552	$ 898	$ 17,585
Payments	(4,687)	(1,349)	(4,068)	(399)	(10,503)
Adjustments to cost in excess of fair value of net assets acquired	(780)	170	180	(299)	(729)
Balance at September 30, 2006	$ 2,742	$ 747	$ 2,664	$ 200	$ 6,353

As a result of the Refinancing, we experienced a significant increase in interest costs, with weighted-average borrowings of $408.8 million at an effective interest rate of 6.3% for the nine-month period ended September 30, 2006 as compared to weighted-average borrowings of $313.9 million at an effective interest rate of 7.4% for the nine-month period ended October 1, 2005.

On April 28, 2006, the Company entered into Amendment No. 1 (Amendment No. 1) to the Senior Credit Facility. Amendment No. 1 reduced the Company s interest rate by refinancing the existing Term Loan B (initially priced at LIBOR + 1.75% with a leverage-based pricing grid ranging from LIBOR + 1.50% to LIBOR + 1.75%) with a new Term Loan 1 having an applicable rate of LIBOR + 1.50% with no leverage-based pricing grid. If the Company makes any optional prepayments of its Term 1 Loans prior to the one-year anniversary of the Amendment No. 1 in connection with any repricing transaction, the Company will be required to pay a prepayment premium of 1% of the amount of such Term 1 Loans being prepaid.

On March 24, 2006, we made a $9.0 million prepayment on our term loan; on May 25, 2006 we made a $15.0 million prepayment on our term loan; and on June 30, 2006 we made a $10.0 million prepayment on our term loan.

At September 30, 2006, we had $392.9 million in Term Loan 1 borrowings and no borrowings under our Revolver, exclusive of approximately $11.3 million of outstanding letters of credit. At December 31, 2005, we had approximately $430.0 million in Term Loan 1 borrowings and no borrowings under our Revolver, exclusive of approximately $20.2 million of outstanding letters of credit.

Principal borrowings under our Term Loan 1 are due and payable in quarterly installments of $1.0 million through June 30, 2012, with the remaining balance of $370.0 million due on July 14, 2012.

Amendment No. 1 also lowered the threshold for permitting restricted payments by raising the required leverage ratio (as defined) from 1.5 times to 2.5 times provided the Company has revolving loan commitments of $75.0 million available.

Our Senior Credit Facility requires us to hedge at least 25% of our variable rate debt under the term loan. On September 22, 2005, we entered into a swap agreement to receive floating interest and pay fixed interest. This swap agreement is designated as a cash flow hedge of the variable interest payments on a portion of our variable rate Term Loan 1 debt. The swap agreement matures on July 30, 2010.

On May 25, 2006, we entered into an interest rate collar agreement (the collar) with a floor of 4.3% and a ceiling of 5.5%. The collar covers $100 million of our variable rate Term Loan 1 debt and is designated as a cash flow hedge of the variable interest payments on such debt. The collar matures on January 31, 2009.

Our Senior Credit Facility also sets forth mandatory and optional prepayment conditions, including an annual excess cash flow requirement, as defined, that may result in our use of cash to reduce our debt obligations.

Based on our current level of operations, we believe that cash generated from operations and available cash, together with amounts available under our Revolver, will be adequate to meet our debt service requirements, capital expenditures, and working capital needs for the foreseeable future, although no assurance can be given in this regard. We may, however, need to refinance all or a portion of amounts outstanding under our Revolver on or before July 14, 2011 and principal outstanding under our Term Loan 1 on or before July 14, 2012.

EFFECTS OF INFLATION AND DEFLATION

We are affected by inflation and changing prices primarily through the sourcing of our products, increased operating costs and expenses, and fluctuations in interest rates. The effects of inflation on our net sales and operations have not been material in recent years. In recent years, there has been deflationary pressure on selling prices. While we have been successful in offsetting such deflationary pressures through product improvements and lower costs with the expansion of our global sourcing network, if deflationary pricing trends outpace our ability to obtain further price reductions from our global suppliers, our profitability may be affected.

SEASONALITY

We experience seasonal fluctuations in our sales and profitability, with generally lower sales and gross profit in the first and second quarters of our fiscal year. Excluding the impact of the Acquisition, over the past five fiscal years, approximately 57% of consolidated net sales were generated in the second half of our fiscal year. With a full year of OshKosh net sales in fiscal 2006, we expect this trend to continue. Accordingly, our results of operations for the first and second quarters of any fiscal year are not indicative of the results we expect for the full fiscal year.

As a result of this seasonality, our inventory levels and other working capital requirements generally begin to increase during the second quarter and into the third quarter of each fiscal year. During these peak periods we have historically borrowed under our revolving credit facility.

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 of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe are 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.

Our significant accounting policies are described in Note 2 to our consolidated financial statements contained in our most recently filed Annual Report on Form 10-K. The following discussion addresses our critical accounting policies, which are those policies that require management s most difficult and subjective judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Revenue recognition: We recognize wholesale and mass channel revenue after shipment of products to customers, when title passes, and when all risks and rewards of ownership have transferred. In certain cases, in which we retain the risk of loss during shipment, revenue recognition does not occur until the goods have reached the specified customer. We consider revenue realized or realizable and earned when the product has been shipped and when all risks and rewards of ownership have transferred, the sales price is fixed or determinable, and collectibility is reasonably assured. In the normal course of business, we grant certain accommodations and allowances to our wholesale and mass channel customers. We provide accommodations and allowances to our key wholesale and mass channel customers in order to assist these customers with inventory clearance and promotions. Such amounts are reflected as a reduction of net sales and are recorded based upon historical trends and annual forecasts. Retail store revenues are recognized at the point of sale. We reduce revenue for customer returns and deductions. We also maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make payments and other actual and estimated deductions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, an additional allowance could be required. Past due balances over 90 days are reviewed individually for collectibility. Our credit and collections department reviews all other balances regularly. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered.

We contract with a third-party service to provide us with the fair value of cooperative (co-op) advertising arrangements entered into with certain of our key wholesale and mass channel customers. Such fair value is determined based upon, among other factors, comparable market analysis for similar advertisements. In accordance with Emerging Issues Task Force Issue No. 01-09, Accounting for Consideration Given by a Vendor to a Customer/Reseller, we have included the fair value of these arrangements of approximately $0.9 million and $2.6 million in the third quarter and first nine months of fiscal 2006 and $1.6 million and $3.2 million in the third quarter and first nine months of fiscal 2005 as a component of selling, general, and administrative expenses on the accompanying unaudited condensed consolidated statement of operations rather than as a reduction of revenue. Amounts determined to be in excess of the fair value of these arrangements are recorded as a reduction of net sales.

Inventory: We provide reserves for slow-moving inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those we project, additional write-downs may be required.

Cost in excess of fair value of net assets acquired and tradename: As of September 30, 2006, we had approximately $602.0 million in cost in excess of fair value of net assets acquired and tradename assets. The fair value of the *Carter s* tradename was estimated at the 2001 acquisition to be approximately $220 million using a discounted cash flow analysis, which examined the hypothetical cost savings that accrue as a result of our ownership of the tradename. The fair value of the *OshKosh* tradename was estimated at the Acquisition to be approximately $102 million also using a discounted cash flow analysis. The cash flows, which incorporated both historical and projected financial performance, were discounted using a discount rate of 10% and 12% for *Carter s* and *OshKosh,* respectively. The tradenames were determined to have indefinite lives. The carrying value of these assets is subject to annual impairment reviews as of the last day of each fiscal year. Factors affecting such impairment reviews include the continued market acceptance of our offered products and the development of new products. Impairment reviews may also be triggered by any significant events or changes in circumstances. Our impairment review of cost in excess of fair value of net assets acquired is based on the estimated fair values of the underlying businesses. These estimated fair values are based on estimates of the future cash flows of the businesses.

Accrued expenses: Accrued expenses for health insurance, workers compensation, incentive compensation, professional fees, and other outstanding obligations are assessed based on actual commitments, statistical trends, and estimates based on projections and current expectations, and these estimates are updated periodically as additional information becomes available.

Accounting for income taxes: As part of the process of preparing our consolidated financial statements, we are required to estimate our actual current tax exposure (state, federal, and foreign), together with assessing permanent and temporary differences resulting from differing bases and treatment of items for tax and accounting purposes, such as the carrying value of intangibles, deductibility of expenses, depreciation of property, plant, and equipment, and valuation of inventories. Temporary differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheets. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. Actual results could differ from this assessment if sufficient taxable income is not generated in future periods. To the extent we determine the need to establish a valuation allowance or increase such allowance in a period, we must include an expense within the tax provision in the accompanying unaudited condensed consolidated statement of operations.

Stock-based compensation arrangements: The Company accounts for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123R. The Company adopted SFAS 123R using the modified prospective application method of transition. The Company uses the Black-Scholes option pricing model, which requires the use of subjective assumptions. These assumptions include the following:

Volatility This is a measure of the amount by which a stock price has fluctuated or is expected to fluctuate. The Company uses actual monthly historical changes in the market value of our stock since the Company s initial public offering on October 29, 2003, supplemented by peer company data for periods prior to our initial public offering covering the expected life of options being valued. An increase in the expected volatility will increase compensation expense.

Risk-free interest rate This is the U.S. Treasury rate as of the grant date having a term equal to the expected term of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected term This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience and estimated future exercise behavior. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. An increase in the expected term will

increase compensation expense.

35

Dividend yield The Company does not have plans to pay dividends in the foreseeable future. An increase in the dividend yield will decrease compensation expense.

Forfeitures The Company estimates forfeitures of stock-based awards based on historical experience and expected future activity. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized in the accompanying unaudited condensed consolidated statement of operations.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The evaluation of a tax position in accordance with this interpretation begins with a determination as to whether it is more likely than not that a tax position will be sustained upon examination based on the technical merits of the position. A tax position that meets the more-likely-than-not recognition threshold is then measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement for recognition in the financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is assessing FIN 48 and has not determined the impact, if any, of the adoption of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective as of the beginning of our 2008 fiscal year. We are currently evaluating the impact of adopting SFAS 157 on our financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132 (R) (SFAS 158). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The provisions of SFAS 158 are effective for the Company as of December 30, 2006, except for the measurement date provisions, which are effective for the Company beginning December 31, 2006. Based on the Company s previously reported unfunded obligation as of December 31, 2005, the adoption of SFAS 158 would reduce total stockholders equity by approximately $1.4 million. The adoption of SFAS 158 will not affect our results of operations. By the time of the adoption at December 31, 2006, plan performance and actuarial assumptions could have a significant impact on the actual amounts recorded. The Company does not believe the adoption of SFAS 158 will have an impact on the Company s financial covenants.

36

FORWARD-LOOKING STATEMENTS

Statements contained herein that relate to our future performance, including, without limitation, statements with respect to our anticipated results of operations or level of business for fiscal 2006 or any other future period, are forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements are based on current expectations only and are subject to certain risks, uncertainties, and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. The factors that could cause actual results to materially differ include a decrease in sales to, or the loss of one or more of our key customers, the acceptance of our products in the marketplace, deflationary pressures on our prices, disruptions in foreign supply sources, negative publicity, increased competition in the baby and young children s apparel market, our substantial leverage, which increases our exposure to interest rate risk, the impact of governmental regulations and environmental risks applicable to our business, our ability to identify new locations and negotiate appropriate lease terms for our retail stores, our ability to attract and retain key individuals within the organization, and seasonal fluctuations in the children s apparel business. These risks are described in our most recently filed Annual Report on Form 10-K under the heading Risk Factors. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

37

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the operation of our business, we have market risk exposures, including those related to foreign currency risk and interest rates. These risks and our strategies to manage our exposure to them are discussed below.

We contract for production with third parties primarily in the Far East and South and Central America. While these contracts are stated in United States dollars, there can be no assurance that the cost for the future production of our products will not be affected by exchange rate fluctuations between the United States dollar and the local currencies of these contractors. Due to the number of currencies involved, we cannot quantify the potential impact of future currency fluctuations on net income in future years. In order to manage this risk, we source products from approximately 100 vendors worldwide, providing us with flexibility in our production should significant fluctuations occur between the United States dollar and various local currencies. To date, such exchange fluctuations have not had a material impact on our financial condition or results of operations. We do not hedge foreign currency exchange rate risk.

Our operating results are subject to risk from interest rate fluctuations on our Senior Credit Facility, which carries variable interest rates. As of September 30, 2006, our outstanding debt aggregated $392.9 million, of which $126.7 million bore interest at a variable rate. An increase of 1% in the applicable rate would increase our annual interest cost by $1.3 million, exclusive of variable rate debt subject to our swap and collar agreements described above, and could have an adverse effect on our net income and cash flow.

OTHER RISKS

There also are other risks in the operation of our business specifically related to our global sourcing network.

We source all of our production from third-party manufacturers primarily located in foreign countries. As a result, we may be adversely affected by political instability resulting in the disruption of trade from foreign countries, the imposition of new regulations relating to imports, duties, taxes, and other charges on imports, including the China safeguards, any significant decreases in the value of the U.S. dollar against foreign currencies, and restrictions on the transfer of funds. These and other factors could result in the interruption of production in offshore facilities, delay receipt of the products into the United States, or affect our operating income. Our future performance may be subject to such factors, which are beyond our control, and there can be no assurance that such factors would not have a material adverse effect on our financial condition and results of operations. We carefully select our sourcing agents, and in an effort to mitigate the possible disruption in product flow, we place production in various countries we believe to be of lower risk.

We enter into various purchase order commitments with full-package suppliers. We can cancel these arrangements, although in some instances, we may be subject to a termination charge reflecting a percentage of work performed prior to cancellation. Historically, such cancellations and related termination charges have occurred infrequently and have not had a material impact on our business. However, as we rely nearly exclusively on our full-package global sourcing network, we expect to incur more of these termination charges, which could increase our cost of goods sold.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

(b) Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

39

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS:

N/A

ITEM 1A. RISK FACTORS:

N/A

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS:

N/A

ITEM 3. DEFAULTS UPON SENIOR SECURITIES:

N/A

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

N/A

ITEM 5. OTHER INFORMATION:

N/A

ITEM 6. EXHIBITS:

(a) Exhibits:

Exhibit Number	**Description of Exhibits**
31.1	Rule 13a-15(e)/15d-15(e) and 13a-15(f)/15d-15(f) Certification
31.2	Rule 13a-15(e)/15d-15(e) and 13a-15(f)/15d-15(f) Certification
32	Section 1350 Certification

41

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.

CARTER S, INC.

Date: November 9, 2006

/s/ FREDERICK J. ROWAN, II
Frederick J. Rowan, II
Chief Executive Officer

Date: November 9, 2006

/s/ MICHAEL D. CASEY
Michael D. Casey
Executive Vice President and
Chief Financial Officer

42

---

nt-size:12px;margin-top:0px;margin-bottom:0px">

	December 31, 2010	December 31, 2009
Current deferred tax asset (included in Other current assets)	$ 814	$ 352
Non-current deferred tax liability	(17,748)	(14,768)
Net deferred tax liabilities after valuation allowance	$ (16,934)	$ (14,416)

F - 19

Table of Contents

The amount of the income tax provision for the years ended December 31, 2010, 2009 and 2008 differs from the statutory federal income tax rate of 35% as follows:

	For the Years Ended December 31,					
	2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent
Tax expense computed at the maximum U.S. statutory rate	$ 16,536	35.0%	$ 11,613	35.0%	$ 13,308	35.0%
Difference resulting from State income taxes, net of federal income tax benefits	269	0.6%	403	1.2%	1,521	4.0%
Foreign tax rate differences	(85)	-0.2%	1,132	3.4%	(1,408)	-3.7%
Foreign dividends received	2,363	5.0%		0.0%		0.0%
Dividends received deduction	(1,042)	-2.2%		0.0%		0.0%
Non-deductible expenses	1,251	2.6%	1,644	5.0%	594	1.6%
Multi-year true-ups (including correction)	2,983	6.3%	(435)	-1.3%	(6,146)	-16.2%
Net gain on outbound transfer	467	1.0%		0.0%		0.0%
Change in valuation allowance	(15,336)	-32.4%	(9,409)	-28.4%	(5,721)	-15.0%
Effective rate differences	(631)	-1.3%		0.0%		0.0%
Other, net	(163)	-0.3%	345	1.0%	1,036	2.7%
Total	$ 6,612	14.0%	$ 5,293	15.9%	$ 3,184	8.4%

The Company has approximately $33.6 million of federal net operating loss carryforwards expiring in 2025 through 2027. The Company has state income tax loss carryforwards of approximately $28.6 million expiring in 2010 through 2029. The Company has approximately $8.5 million in foreign tax credit carryforwards expiring in 2015 through 2019.

The Company provides income taxes on the undistributed earnings of its foreign subsidiaries except to the extent that such earnings are indefinitely reinvested outside the United States. As of December 31, 2010, all of the undistributed earnings of the foreign subsidiaries, approximately $3.4 million, were considered to be reinvested indefinitely. Consequently, the Company has not provided for the federal and foreign withholding taxes on the foreign subsidiaries undistributed earnings. If the Company decided to repatriate all available foreign cash it would have zero impact on the total tax provision.

Effective January 1, 2007, the Company adopted ASC 740, *Income Taxes,* as it relates to uncertain tax positions. Currently, the Company is not under examination for income tax purposes by any taxing jurisdiction. A presentation of open tax years by jurisdiction is as follows:

Tax Jurisdiction	Examination in Progress	Open Tax Years for Examination
United States	None	2005 to Present
Mexico	None	2004 to Present
China	None	2004 to Present
The Netherlands	None	2007 to Present

The Company has elected to classify interest and penalties related to uncertain income tax positions in income tax expense. At December 31, 2010, 2009 and 2008, the Company has accrued approximately $2.1 million, $1.7 million and $1.2 million, respectively, for potential payment of interest and penalties.

Table of Contents

Following is a reconciliation of the total amounts of unrecognized tax benefits for the years ended December 31, 2010, 2009 and 2008 (in thousands):

	For the Years Ended December 31,		
	2010	**2009**	**2008**
Unrecognized Tax Benefits at January 1	$ 4,242	$ 4,046	$ 3,499
Change in Unrecognized Tax Benefits Taken During a Prior Period			
Change in Unrecognized Tax Benefits During the Current Period	136	583	547
Decreases in Unrecognized Tax Benefits From Settlements with Taxing Authorities	(479)	(387)	
Reductions to Unrecognized Tax Benefits From Lapse of Statues of Limitations			
Unrecognized Tax Benefits at December 31	$ 3,899	$ 4,242	$ 4,046

The Unrecognized Tax Benefits disclosed previously for 2009 and 2008 differ from the Unrecognized Tax Benefits disclosed above by $1.7 million and $1.2 million, respectively. This decrease results from the Company s decision to remove accrued interest and penalties from the tabular rollforward. This is being done to better comport with how the disclosure of unrecognized tax benefits has evolved since the passage of ASC 740. This change in disclosure has no impact on the amounts recognized in the accompanying consolidated balance sheets. As of December 31, 2010, 2009 and 2008 the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate are approximately $1.8 million, $1.9 million and $1.7, million respectively.

NOTE 6 UNCOMPLETED CONTRACTS

Both the Products and Services Divisions enter into contracts that allow for periodic billings over the contract term. At any point in time, each project under construction could have either costs and estimated earnings in excess of billings or billings in excess of costs and estimated earnings. Within the Products Division, the Auxiliary Power Equipment business typically bills customers only at the completion of each phase of a contract and no earnings are recognized until each phase is complete.

Costs, earnings and billings related to uncompleted contracts consist of the following (in thousands):

	For the Years Ended December 31,	
	2010	**2009**
Costs incurred on uncompleted contracts	$ 420,552	$ 433,124
Earnings recognized on uncompleted contracts	60,652	(128,822)
Total	481,204	304,302
Less - billings to date	(459,463)	(305,980)
Net	$ 21,741	$ (1,678)

The net amounts are included in the accompanying consolidated balance sheets under the following headings (in thousands):

	December 31, 2010	**December 31, 2009**
Costs and estimated earnings in excess of billings	$ 33,076	$ 29,470
Billings in excess of costs and estimated earnings	(11,335)	(31,148)
Net	$ 21,741	$ (1,678)

NOTE 7 DEBT

Credit Facility: The Company has a $150 million Credit Facility (Credit Facility) consisting of a $60 million revolving letter of credit facility, including a $25 million cash advance sub-facility, and a $90 million term loan facility. On November 18, 2010, the Company repaid the outstanding balance of the term loan facility and all related interest in full. At December 31, 2010, the Company had $25.0 million of unused capacity on the cash advance sub-facility. The Credit Facility will terminate on January 22, 2014 and any amounts outstanding at that time will be due and payable in full.

Table of Contents

At December 31, 2010 and 2009, the Credit Facility consisted of the following (in thousands):

	As of December 31, 2010	2009
Term loan	$	$ 65,325
Less:		
Current maturities of long-term debt		
Quarterly installments		5,000
Excess cash flow sweep		35,692
Long-term debt, net of current maturities	$	$ 24,633

The interest rate on letters of credit issued under the revolving letter of credit was 3.82% at December 31, 2010. The Company also pays an unused line fee of 0.50%. Should the Company need to borrow against the revolver facility it would pay interest at 3.82% per annum.

The Credit Facility includes customary affirmative and negative covenants, such as limitations on the creation of new indebtedness and on certain liens, restrictions on certain transactions and payments and requires maintenance of a maximum consolidated leverage ratio, minimum consolidated fixed charge ratio and minimum liquidity. A default under the Credit Facility may be triggered by events such as a failure to comply with financial covenants or other covenants under the Credit Facility, a failure to make payments when due under the Credit Facility, a change of control of the Company or certain insolvency proceedings. A default under the Credit Facility would permit the participating banks to restrict the Company s ability to further access the Credit Facility for loans, require the immediate repayment of any outstanding loans with interest and require the cash collateralization of outstanding letter of credit obligations. The Credit Facility is secured by a first priority lien on substantially all assets of the Company.

NOTE 8 LIABILITIES SUBJECT TO COMPROMISE

Liabilities subject to compromise include unsecured and under secured liabilities, including secured liabilities as to which there is uncertainty as to whether the value of the collateral securing such liabilities is less than, equals or exceeds such liabilities, incurred prior to the petition date. The amounts of the various categories of liabilities that are subject to compromise are set forth below. These amounts represent the Company s estimates of known or potential pre-petition date claims that are likely to be resolved in connection with the Chapter 11 filings. Such claims remain subject to further adjustments. Adjustments result from negotiations, actions of the Bankruptcy Court, rejection of executory contracts, the determination as to the value of any collateral securing claims, proofs of claim or other events.

The amounts of liabilities subject to compromise at December 31, 2010 consisted of the following (in thousands):

	Products Division	Services Division	Corporate	Total
Accounts payable	$	$ 7	$	$ 7
Other accruals			200	200
Total	$	$ 7	$ 200	$ 207

The amounts of liabilities subject to compromise at December 31, 2009 consisted of the following (in thousands):

	Products Division	Services Division	Corporate	Total
Accounts payable	$ 92	$ 30	$	$ 122
Other accruals	109		310	419

Total	$ 201	$ 30	$ 310	$ 541

Table of Contents

NOTE 9 STOCKHOLDERS EQUITY

Restricted Stock Awards: Pursuant to the 2008 Director s Equity Incentive Plan, the Company is permitted to award restricted stock subject to specified restrictions on transfer, forfeiture and/or such other restrictions on incidents of ownership determined by the Compensation Committee of the Company s Board of Directors. On January 22, 2009, the Company issued 26,144 shares of restricted stock under the 2008 Director s Equity Incentive Plan at a grant date fair value of $5.76 per share, which approximated the quoted market price of the common stock on that date. Vesting of this restricted stock is based on certain service conditions over a four year period.

On February 9, 2009, the Company issued 34,722 shares of restricted stock under the 2008 Director s Equity Incentive Plan at a grant date fair value of $4.95 per share, which approximated the quoted price of the common stock on that date. Vesting of this restricted stock is based on certain service conditions over a four year period.

On February 9, 2010, the Company granted 17,361 shares of restricted stock under the 2008 Director s Equity Incentive Plan at a grant date fair value of $15.75 per share, which approximated the quoted price of the common stock on that date. Vesting of this restricted stock is based on certain service conditions over a four year period.

The following table summarizes the expense related to these restricted stock awards (in thousands):

	For the Years Ended December 31,			Future Vesting periods
	2010	2009	2008	
Restricted stock awards granted:				
January 22, 2009	$ 37	$ 73	$	$ 41
February 9, 2009	43	39		90
February 9, 2010	63			211
Total	$ 143	$ 112	$	$ 342

Stock-based Compensation: On June 23, 2008, the Company granted 581,546 RSUs with a grant date fair value of $10.80 per unit under the 2008 Management Incentive Plan pursuant to RSU Award Agreements executed by each beneficiary of the grant. Grants of RSUs under the 2008 Management Incentive Plan are valued in terms of the quoted market price of the Company s common stock at date of grant; however, common stock is not issued at the time of the grant. Vesting of RSUs is based on certain performance and service conditions over a four year period. The Company recognizes compensation cost for awards with performance conditions if and when the Company concludes that it is probable that the performance condition will be achieved, net of an estimate of pre-vesting forfeitures. The Company recognizes compensation cost for awards with service condition throughout the vesting term, net of an estimate of pre-vesting forfeitures. Restricted shares are issued to plan participants as vesting requirements are satisfied. In addition, on March 2, 2010, the Company issued 7,935 shares of restricted stock to the recipients of RSU awards according to specific separation agreements.

On February 9, 2009, the Company granted 540,008 RSUs with a grant date fair value of $4.95 per unit under the 2008 Management Incentive Plan. In addition, on September 14, 2009, the Company granted 83,333 RSUs with a grant date fair value of $10.80 per unit under the 2008 Management Incentive Plan. Additionally, on March 2, 2010, the Company issued 11,842 shares of restricted stock to certain recipients of RSU awards pursuant to individual separation agreements.

On March 23, 2010, the Company granted 458,888 RSUs with a grant date fair value of $15.75 per unit under the 2008 Management Incentive Plan.

The following table summarizes the expense related to these restricted stock units (in thousands):

	For the Years Ended December 31,		
	2010	2009	2008
Restricted stock units granted:			

June 23, 2008	$ 949	$ 866	$ 1,173
February 9, 2009	1,251	620	
March 23, 2010	1,345		
Total	$ 3,545	$ 1,486	$ 1,173

Stock-based Compensation - Withheld: In April 2010, the Company issued 228,300 shares of common stock to the participants in the 2008 Management Incentive Plan pursuant to the vesting schedule. Some employees elected to have some of their shares withheld for tax purposes resulting in a $0.6 million adjustment to Paid-in Capital.

Management Co-Investment Plan: On January 22, 2008, members of management were offered the opportunity to purchase shares of the new common stock (up to an aggregate amount of $1.5 million) at the share price of $7.65 per share. With each purchase of two shares of new common stock, an additional share of restricted stock (each an Incentive Share) was issued. At March 31, 2010, 2,136 shares of common stock issued under the Management Co-Investment Plan were forfeited by members of management who terminated their employment with the Company prior to meeting the vesting requirements. These shares are held as treasury shares.

The following table summarizes the expense related to the Management Co-Investment Plan (in thousands):

	For the Years Ended December 31,			Future Vesting periods
	2010	2009	2008	
Management Co-Investment Plan				
January 22, 2008	$ 158	$ 225	$ 181	$ 14
Total	$ 158	$ 225	$ 181	$ 14

Warrants: On January 22, 2008, the Company issued warrants to purchase 1,807,222 shares of stock with an exercise price of $7.9254. The warrants vested immediately upon issuance and expire on January 22, 2013. During the year ended December 31, 2010, warrants were exercised to purchase 88,439 shares of common stock. The stock was sold in a cashless transaction whereby the Company withheld 30,066 shares of common stock, treasury shares, as payment of the exercised purchase warrants.

Fair Market Value of Interest Rate Swap: On March 28, 2008, the Company entered into a swap agreement to convert $60 million of the Credit Facility variable interest payments to fixed rates. The amount of accumulated comprehensive income associated with interest rate swaps was $0 at December 31, 2010, a loss of $0.2 million at December 31, 2009 and $0.8 million at December 31, 2008. See Note 2 for a discussion of the interest rate swaps.

Foreign Currency Translation: Foreign assets and liabilities are translated using the exchange rate in effect at the balance sheet date, and results of operations are translated using an average rate for the period. Translation adjustments are accumulated and reported as a component of accumulated other comprehensive income. The amount of accumulated comprehensive gain related to foreign currency translation was $1.4 million at December 31, 2010, $2.8 million at December 31, 2009, and $1.9 million at December 31, 2008.

Issuance of Common Stock: Pursuant to the Plan, each holder of an equity interest as of November 6, 2007 received a non-transferable, non-certificated right (a Right) to purchase up to its Pro Rata shares of the new common stock (the Rights Offering). The Rights Offering commenced on November 6, 2007 and expired on December 13, 2007. As a result, on January 22, 2008, the Company issued 14,744,009 shares of new common stock and raised $72.5 million of new equity capital at an applicable share price of $7.65 per share. Of the $72.5 million of net cash proceeds received, $4.6 million was the value assigned to the warrants offset by $0.5 million assigned to the cancellation of 5,261,553 shares of common stock at December 31, 2007 and the remaining $68.4 million was credited to stockholders equity.

In addition, pursuant to the Plan the Company issued 112,014 shares of common stock for advisor success fees related to the bankruptcy. As a result, the Company charged expense and attributed an additional $0.8 million in paid in capital at an applicable share price of $7.65 per share.

NOTE 10 COMMITMENTS AND CONTINGENCIES

Employment Agreements: The Company entered into employment agreements with terms of two to three years with certain members of management with automatic one-year renewal periods at expiration dates. The agreements provide for, among other things, compensation, benefits and severance payments.

Litigation: The Company is involved from time to time in legal actions that arise in the ordinary course of our business. The Company does not believe that the resolution of any currently pending actions, either individually or in the aggregate, will have a material adverse effect on the Company s financial position or results of operations. However, the outcomes of any legal actions cannot be predicted, and therefore, there can be no assurance that this will be the case.

Deltak Fund for Unsecured Claims in Bankruptcy: On September 28, 2006, Global Power Equipment Group Inc. and all of its U.S. subsidiaries, including Deltak, filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy

Court for the District of Delaware. Pursuant to an approved Plan of Reorganization, an administrator was appointed to administer a fund of approximately $34 million in cash that was intended to be distributed to the holders of allowed unsecured claims against Deltak. Under the Plan of Reorganization, the administrator has the right and duty to administer the fund and to make, file and settle or otherwise resolve objections to unsecured claims against Deltak.

Table of Contents

Each of Mitsubishi Heavy Industries, Ltd. and Mitsubishi Power Systems Americas, Inc. initially filed a claim against Deltak in the amount of $38.3 million allegedly arising from a pre-bankruptcy contract with Deltak. After prosecution of the pending objection by the administrator, in late 2010, the administrator, the Mitsubishi entities, Deltak and Global Power entered into a settlement whereby the administrator made a cash payment of $1.1 million from the fund to the Mitsubishi entities in full satisfaction of their claims and the parties provided mutual releases.

Since January 22, 2008, the administrator has adjudicated and/or settled various unsecured claims and engaged in efforts to resolve the remaining disputed claims. As of February 28, 2011, approximately $2.8 million of cash remains in the fund subject to the control of the administrator.

Certain disputed unsecured claims remain unresolved. The administrator continues to contest and otherwise seek to resolve these and all other remaining disputed claims.

Asbestos Cases: The Company has been named as a defendant in a limited number of asbestos personal injury lawsuits. Neither the Company nor its predecessors ever mined, manufactured, produced or distributed asbestos fiber, the material that allegedly caused the injury underlying these actions. The bankruptcy court s discharge order issued upon emergence from bankruptcy extinguished the claims made by all plaintiffs who had filed asbestos claims against the Company before that time. The Company also believes the bankruptcy court s discharge order should serve as a bar against any later claim filed against it, including any of its subsidiaries, based on alleged injury from asbestos at any time before emergence from bankruptcy. In any event in all of the asbestos cases finalized post-bankruptcy, the Company has been successful in having such cases dismissed without liability. The Company intends to vigorously defend all currently active actions, just as it defended the other actions that have since been dismissed, all without liability, and it does not anticipate that any of these actions will have a material adverse effect on its financial position, results of operations or liquidity. However, the outcomes of any legal action cannot be predicted and, therefore, there can be no assurance that this will be the case.

Warranty: Estimated costs related to product warranty are accrued as revenue is recognized and included in the cost of revenues. Estimated costs are based upon past warranty claims and sales history. Warranty terms vary by contract but generally provide for a term of three years or less. The Company manages its exposure to warranty claims by having its field service and quality assurance personnel regularly monitor projects and maintain ongoing and regular communications with the customer.

A reconciliation of the changes to the Company s warranty reserve is as follows (in thousands):

	For the Years Ended December 31, 2010	2009
Balance at the beginning of the period	$ 10,981	$ 11,948
Adjustments [1]	(3,501)	(1,393)
Provision during the period	187	1,912
Settlements made (in cash or in kind) during the period	(1,618)	(1,486)
Balance at the end of the period	$ 6,049	$ 10,981

[1] During 2010 and 2009 warranty adjustments included the normal roll off of warranty periods and changes in managements estimates, based on historical claims activity, to further reduce the warranty reserves required.

Leases: The Company leases machinery, transportation equipment and office, warehouse and manufacturing facilities under leases, which are noncancellable and expire at various dates. Total rental expense for all operating leases for 2010, 2009 and 2008 was approximately $1.5 million, $1.6 million and $1.9 million, respectively.

Table of Contents

Future minimum annual lease payments under these noncancellable operating leases at December 31, 2010 are as follows (in thousands):

	December 31
2011	998
2012	758
2013	682
2014	553
2015	202
Thereafter	103
Total	$ 3,296

None of the leases include contingent rental provisions.

Employee Benefit Plans: The Company maintains a 401(k) plan covering substantially all of the Company s employees in the United States. Expense for the Company 401(k) plan for 2010, 2009 and 2008 was approximately $1.7 million, $1.3 million and $1.1 million, respectively.

Contingencies: At December 31, 2010 and 2009, the Company had a contingent liability for issued and outstanding stand-by letters of credit, generally issued to secure performance on customer contracts. The balance of stand-by letters of credit totaled approximately $17.9 million for the domestic entities and $13.5 million (U.S. dollars) for foreign entities at December 31, 2010 and $22.2 million for the domestic entities and $13.3 million (U.S. dollars) for foreign entities at December 31, 2009. Currently, there are no amounts drawn upon these letters of credit. In addition, at December 31, 2010 and 2009, the Company had outstanding surety bonds on projects of approximately $13.0 million and $8.5 million, respectively.

The Company participates in several multi-employer pension plans throughout the United States. As of December 31, 2010, the Company received notices from certain plans that are in critical funding status; however, the Company has not withdrawn from any of these plans. Currently, each plan is developing a rehabilitation plan that may call for a reduction on participant benefits or an increase in future employer contributions. While it is reasonably possible that additional expenses may be incurred related to these plans, management cannot, at this time, estimate the amount, or range, of the potential exposure. The Company continues to monitor and assess any full and partial withdrawal liability implications associated with these plans.

The Company evaluated its banking relationships with regard to cash and available credit. The Company maintains cash in depository accounts at various FDIC insured banks and financial institutions and, at times, balances may exceed federally insured limits. We have never experienced any losses related to these balances. All of the Company s non-interest bearing cash balances were fully insured at December 31, 2010 due to a temporary federal program in effect from December 31, 2010 through December 31, 2012. Under the program, there is no limit to the amount of insurance for eligible accounts. Beginning 2013, insurance coverage will revert to $250,000 per depositor at each financial institution, and the Company s non-interest bearing cash balances may again exceed federally insured limits. Although the Company maintains cash balances in interest bearing accounts in excess of the FDIC insured limits, management believes this risk is mitigated by using financial institutions that are rated investment grade according to credit rating agencies. To the extent that the credit crisis affects the counterparties in the Credit Facility, the Company may have difficulty accessing all the available credit under this facility.

Table of Contents

NOTE 11 SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow disclosures are as follows (in thousands):

	For the Years Ended December 31,		
	2010	**2009**	**2008**
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the period for:			
Interest	$ 3,950	$ 8,848	$ 11,632
Income taxes	957	976	1,812
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES:			
Issuance of Common Shares for advisor success fees pursuant to the Plan of Reorganization	$	$	$ 856

NOTE 12 SEGMENT INFORMATION

The Management Approach called for by ASC 280, *Segment Reporting,* has been used by Company management to present the segment information which follows. The Company considered the way its management team makes operating decisions and assesses performance and considered which components of its enterprise have discrete financial information available. Management makes decisions using a products and services group focus and its analysis resulted in two operating segments, Products Division and Services Division. The Company evaluates performance based on net income or loss not including certain items as noted below. Intersegment revenues and transactions were not significant. Interest expense is allocated based on the amount of capital employed for each division. Corporate assets consist primarily of cash and deferred tax assets.

The following tables present information about segment income (in thousands):

	Products Division Years Ended December 31,			Services Division Years Ended December 31,		
	2010	**2009**	**2008**	**2010**	**2009**	**2008**
Revenues	$ 142,683	$ 193,150	$ 311,603	$ 377,461	$ 347,460	$ 245,161
Interest expense	3,646	4,713	6,744	3,406	4,954	4,923
Depreciation and amortization	1,893	1,936	1,711	2,167	2,215	2,081
Income tax provision	1,928	3,560	2,568	4,482	1,722	583
Segment income	10,512	9,088	32,976	25,675	9,724	1,768
Total Assets	$ 121,056	$ 126,288	$ 153,148	$ 103,792	$ 125,015	$ 94,469

The following table presents information, which reconciles segment income to consolidated net income (in thousands):

	Years ended December 31,		
	2010	**2009**	**2008**
Net income:			
Total segment income	$ 36,187	$ 18,812	$ 34,744
Income from discontinued operations	2,971	7,369	23,668
Gain on sale of discontinued operations		2,736	
Reorganization (expense) income	1,477	(1,030)	(23,574)
Consolidated net income	$ 40,635	$ 27,887	$ 34,838

The following table presents information, which reconciles segment assets to consolidated total assets (in thousands):

	As of December 31,	
	2010	2009
Assets:		
Total segment assets	$ 224,848	$ 251,303
Non allocated corporate assets	40,877	74,708
Total consolidated assets	$ 265,725	$ 326,011

The following presents revenues by geographical region based on the Company s operating locations. Products are often shipped to other geographical areas but revenues are listed in the region in which the revenue is recognized (in thousands):

	Years ended December 31,					
	2010		2009		2008	
	Revenue Recognized In	Revenue Rendered	Revenue Recognized In	Revenue Rendered	Revenue Recognized In	Revenue Rendered
United States	$ 476,524	$ 430,225	$ 486,598	$ 413,780	$ 458,075	$ 350,462
Canada		9,585		11		22,050
Europe	32,009	11,668	38,471	31,345	80,792	20,704
Mexico	7,522	744	10,518	364	16,350	116
Asia	4,089	26,236	5,023	26,113	1,547	17,999
Middle East		22,891		63,681		112,374
Other		18,795		5,316		33,059
Total	$ 520,144	$ 520,144	$ 540,610	$ 540,610	$ 556,764	$ 556,764

Table of Contents

NOTE 13 SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

A summary of the quarterly operating results during 2010 and 2009 follows:

Year Ended December 31, 2010	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	2010 Total
		(In Thousands, Except Per Share Amounts)			
Total revenues	$ 157,150	$ 124,660	$ 116,454	$ 121,880	$ 520,144
Gross profit	25,257	24,147	27,033	26,084	102,521
Income from continuing operations	10,106	8,516	14,650	4,392	37,664
Earnings (loss) per share from continuing operations: [1]					
Basic	0.66	0.56	0.96	0.29	2.47
Diluted	0.63	0.52	0.89	0.27	2.31

Year Ended December 31, 2009	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	2009 Total
		(In Thousands, Except Per Share Amounts)			
Total revenues	$ 125,974	$ 155,805	$ 95,784	$ 163,047	$ 540,610
Gross profit	26,230	27,802	14,023	12,370	80,425
Income from continuing operations	12,016	10,702	1,013	(5,949)	17,782
Earnings (loss) per share from continuing operations: [1]					
Basic	0.80	0.71	0.07	(0.39)	1.19
Diluted	0.79	0.69	0.06	(0.38)	1.14

[1] The earnings (loss) per share is calculated from the weighted average common and common stock equivalents outstanding during each quarter, which may fluctuate based on quarterly income levels and market prices. Therefore, the sum of earnings per share information for each quarter may not equal the total year amounts.

During 2010, the Company:

- incurred an additional $1.8 million in interest in the fourth quarter expense related the acceleration of debt issuance costs related to paying of the term note in the Credit Facility;

- incurred an increase in professional fees of $1.1 million related to our public company registration;

- received from the U.S. Bankruptcy Court an approved settlement of certain claims against us and our Deltak subsidiary. As a result of that settlement and the related compromise by the Company of its own claim against the fund that had been established pursuant to the Company s Plan of Reorganization to be distributed to holders of allowed unsecured claims against Deltak, The Company received a cash payment of $2.8 million on July 27, 2010 and recognized such amount as revenue at that time; and

- experienced favorable warranty reserve adjustments of $3.1 million related to the normal roll off of warranty periods and changes in managements estimates, based on historical claims activity, to further reduce the warranty reserves required.

During 2009, the Company:

experienced a gain on disposal of discontinued operations of $2.7 million resulting from a settlement agreement that was executed outlining the release of certain escrow funds pursuant to the sale of Global Power Asia, Ltd. in October 2007; and

experienced $10.7 million of cost overruns on a percentage-of-complete contract recognized late in 2009.

Table of Contents

Schedule II

VALUATION AND QUALIFYING ACCOUNTS

YEARS ENDED DECEMBER 31, 2010, 2009 AND 2008

(in thousands)	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions	Balance at End of Period
2010					
Allowance for doubtful accounts	$ 1,588	$ 1,718	$	$ (798)	$ 2,508
Accrued warranty reserves	$ 10,981	$ 187	$	$ (5,119)	$ 6,049
Valuation allowance for deferred tax assets	$ 92,033	$ (36,797)	$	$	$ 55,236
2009					
Allowance for doubtful accounts	$ 3,122	$ 115	$	$ (1,649)	$ 1,588
Accrued warranty reserves	$ 11,948	$ 1,912	$	$ (2,879)	$ 10,981
Valuation allowance for deferred tax assets	$ 102,535	$ (10,502)	$	$	$ 92,033
2008					
Allowance for doubtful accounts	$ 8,001	$ 8,283	$	$ (13,162)	$ 3,122
Accrued warranty reserves	$ 5,948	$ 6,550	$	$ (550)	$ 11,948
Valuation allowance for deferred tax assets	$ 108,257	$ (5,722)	$	$	$ 102,535

The deductions column of allowance for doubtful accounts represents write-offs of fully reserved accounts receivable net of recoveries.

The deductions column for accrued warranties represents settlements made during the period and the expiration of warranties on contracts sold in prior years that did not utilize the related reserve balance.