

AMERICAN APPAREL, INC  
Form 10-K  
March 16, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

**Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the fiscal year ended December 31, 2008

or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-32697

**American Apparel, Inc.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State of Incorporation)

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

**747 Warehouse Street**

**Los Angeles, California 90021-1106**

(Address of principal executive offices) (Zip code)

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

**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock, par value \$.0001 per share**  
(Title of Each Class)

**NYSE Alternext US**  
(Name of Each Exchange on Which Registered)

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "accelerated filer", "large accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2008 was approximately \$463,614,047 based upon the closing price of the common stock on such date as reported by the American Stock Exchange (now the NYSE Alternext US).

The number of shares of the registrant's common stock outstanding as of March 12, 2009 was 71,033,757.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the proxy statement for the registrant's 2009 Annual Meeting of Stockholders (the 2009 Proxy Statement), to be filed within 120 days of the end of the fiscal year ended December 31, 2008, are incorporated by reference into Part III herein. Except with respect to the information specifically incorporated by reference in Part III of this Form 10-K, the 2009 Proxy Statement is not deemed to be filed as part of this Form 10-K.

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

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

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

future financial condition and operating results;

our ability to remain in compliance with financial covenants under our financing arrangements;

our plan to make continued investments in advertising and marketing;

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

the outcome of litigation matters;

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

our personnel, consultants, and collaborators;

operations outside the United States;

economic and political conditions;

overall industry and market performance;

the impact of accounting pronouncements;

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management's goals and plans for future operations; and

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

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements, which are qualified in their entirety by this cautionary statement. Forward-looking statements are subject to numerous assumptions, events, risks, uncertainties and other factors, including those that may be outside of our control and that change over time. As a result, actual results and/or the timing of events could differ materially from those expressed in or implied by the forward-looking statements and future results could differ materially from historical performance. Such assumptions, events, risks, uncertainties and other factors include, among others, those described under Item 1A and elsewhere in this report, as well as in other reports and documents we file with the United States Securities and Exchange Commission (the "SEC") and include, without limitation, the following:

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

consequences of our significant indebtedness, including our ability to comply with our debt agreements and generate cash flow to service our debt;

disruptions in the global financial markets;

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increasing competition;

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

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

effectively carrying out and managing our growth strategy;

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

fluctuations in comparable store sales and margins;

seasonality;

costs of materials and labor;

location of our facilities in the same geographic area;

manufacturing, supply or distribution difficulties or disruptions;

risks of financial nonperformance by customers;

investigations, enforcement actions and litigation;

compliance with or changes in laws and regulations;

costs as a result of operating as a public company;

material weaknesses in internal controls;

interest rate and foreign currency risks;

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

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

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

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

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**American Apparel, Inc.**

**ANNUAL REPORT ON FORM 10-K**

**FOR THE YEAR ENDED DECEMBER 31, 2008**

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**PART I**

**Item 1. Business**  
**Background of American Apparel, Inc.**

American Apparel, Inc., a Delaware corporation, was incorporated in Delaware on July 22, 2005 as Endeavor Acquisition Corp., a blank check company formed to acquire an operating business. On December 21, 2005, Endeavor Acquisition Corp. consummated its initial public offering, and on December 18, 2006, entered into an Agreement and Plan of Reorganization, amended November 7, 2007, with American Apparel, Inc., a California corporation ( Old American Apparel ), and its affiliated companies. Endeavor Acquisition Corp. consummated the acquisition of Old American Apparel and its affiliated companies on December 12, 2007 (the Acquisition ) and changed its name to American Apparel, Inc. Pursuant to the Acquisition, Old American Apparel merged with and into AAI Acquisition LLC, a Delaware limited liability company and a wholly owned subsidiary of Endeavor Acquisition Corp. AAI Acquisition LLC survived the acquisition as a wholly owned subsidiary of the Company and changed its name to American Apparel (USA), LLC.

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

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

**Overview**

American Apparel is a vertically-integrated manufacturer, distributor, and retailer of branded fashion basic apparel based in downtown Los Angeles, California. As of December 31, 2008, American Apparel operated 260 retail stores in 19 countries, including the United States, Canada, Mexico, Brazil, United Kingdom, Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland, Israel, Australia, Japan, South Korea and China. American Apparel also operates a leading wholesale business that supplies t-shirts and other casual wear to distributors and screen printers. In addition to its retail stores and wholesale operations, American Apparel operates an online retail e-commerce website at [www.americanapparel.com](http://www.americanapparel.com).

American Apparel currently has the following domestic subsidiaries: American Apparel LLC, American Apparel (USA), LLC, American Apparel Retail, Inc., American Apparel Dyeing and Finishing, Inc., and KCL Knitting, LLC. Additionally, American Apparel operates its retail and wholesale business through the following direct and indirect foreign subsidiaries: American Apparel Canada Wholesale Inc., American Apparel Canada Retail Inc., Fresh Air Freight, Inc., American Apparel Deutschland GmbH, American Apparel Spain, S.L., American Apparel Italia SRL, American Apparel (UK) Limited, American Apparel (Carnaby) Limited, American Apparel Mexico, Sde RL de CV, American Apparel Mexico Labor, Sde RL de CV, American Apparel Japan Yugen Kaisha, American Apparel Korea Co., Ltd., American Apparel Australia Pty Ltd., American Apparel Retail (Israel), Ltd., American Apparel Ireland Limited, American Apparel New do Brasil Comercio de Roupas Ltd, American Apparel Iceland ehf, American Apparel (Beijing) Trading Company, Ltd. and American Apparel New Zealand, Limited.

American Apparel operates principally out of a 800,000 square foot facility in downtown Los Angeles, California that houses its executive offices, as well as cutting, sewing, and distribution operations. American Apparel operates a knitting facility in Los Angeles, a dyeing and finishing facility in Hawthorne, California, a sewing, dyeing and finishing facility in South Gate, California and a knitting and dyeing facility in Garden Grove, California. The Company's domestic manufacturing operations allow American Apparel to quickly

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respond to customer demand, react quickly to changing fashion trends and closely monitor quality. The Company's garments are noted for their quality and fit, and the Company's distinctive branding has differentiated it in the marketplace. American Apparel® is a registered trademark of American Apparel (USA), LLC.

Old American Apparel was founded in 1998. Since inception, American Apparel has operated its wholesale business. In October 2003, American Apparel opened its first retail store in Los Angeles. In 2004, American Apparel began its online retail operations, and opened its first stores in Canada and Europe. Since 2005, American Apparel has opened stores in Asia, Australia, Israel, Brazil and Mexico, and has further expanded throughout the U.S., Canada and Europe.

## **Business Segments**

The business reporting segments of the Company are U.S. Wholesale, U.S. Retail, Canada, and International. The Company believes this method of segment reporting reflects both the way its business segments are managed and the way each segment's performance is evaluated. The U.S. Wholesale segment includes the Company's wholesale and online consumer operations in the U.S. The U.S. Retail segment includes the Company's retail operations in the U.S. The Canada business segment includes retail, wholesale and online operations in Canada. The International segment includes retail, wholesale and online operations outside of the U.S. and Canada. The results of the respective business segments exclude corporate expenses, which consist of the shared overhead costs of the Company. These costs are presented separately and generally include, among other things, the following corporate costs: information technology, human resources, accounting and finance, executive compensation and legal. Financial information about each segment, together with certain geographical information, for the fiscal years ended December 31, 2008, 2007 and 2006 are included in Note 18 to the Consolidated Financial Statements contained herein.

In 2008, 29.8% from U.S. Wholesale operations, 31.0% of our net revenue was generated from U.S. Retail operations, 12.3% from Canada operations and 26.9% from International operations. Total net revenue for 2008 was \$545.0 million and total net earnings for 2008 were \$14.1 million.

## **Core Business Strengths**

American Apparel has relied on a number of core business strengths that it believes have contributed to its past success and will contribute to its future growth:

### *Design Vision*

American Apparel's design vision and aesthetic are intended to appeal to young, metropolitan adults by providing them with a core line of iconic, timeless styles offered year-round in a wide variety of colors at reasonable prices. Since its founding, American Apparel has operated with the belief that there is a large potential market among young adults for well-designed, high-quality fashion essentials. Led by Dov Charney, the Company's Chairman of the Board of Directors, Chief Executive Officer and President, the Company's in-house creative team has carefully developed the Company's product line.

### *Advertising and Branding*

American Apparel attracts customers through internally-developed, edgy, high-impact, visual advertising campaigns which use print, outdoor, in-store, and electronic communication vehicles. These advertising campaigns communicate a distinct brand image that differentiates the Company from its competitors and seek to establish a connection with the Company's customers. The Company's retail stores are an important part of American Apparel's branding and convey a modern, internationalist lifestyle. At various times, the Company has also drawn attention to the Made in USA nature of its products and the Sweatshop Free environment in which the Company's garments are produced.

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### *Speed to Market*

The Company's vertically integrated business model, with manufacturing and various other elements of the Company's business processes centered in downtown Los Angeles, allows the Company to play a role in originating and defining new and innovative trends in fashion, while enabling the Company to quickly respond to market and customer demand for classic styles and new products. For the Company's wholesale operations, being able to fulfill large orders with quick turn-around allows American Apparel to capture business. The ability to quickly respond to the market quickly means that the Company's retail operations can deliver on-trend apparel in a timely manner, adhere to a policy of not discounting product at retail stores and maximize sales on popular styles by replenishing product that would have otherwise sold out.

### *Quality*

American Apparel prides itself on its use of quality fabrics. American Apparel has an active quality control department that oversees the in-house production of fabric at its knitting facilities. The quality control department also supervises outside knitting contractors who work to the Company's strict specifications. The quality control department watches closely over the cutting, sewing, dyeing and finishing of our garments at our Los Angeles area facilities. Because cutting and sewing operations are conducted mostly in-house, American Apparel believes it has the ability to exercise greater control over clothing manufacturing than competitors who use contract sewing facilities.

### *Broad Appeal*

While initially targeted towards young, metropolitan adults in the U.S., the clean, simple styles and quality of the Company's garments have helped American Apparel appeal to various demographics around the world. The Company believes that its appeal has been augmented by, and should continue to benefit from, growing trends toward casual attire and higher quality apparel.

## **Growth Strategy**

As American Apparel continues to expand through organic growth, internal initiatives and future acquisitions, it will incur additional material expenses. Two of the key areas in which such increased expenses will likely occur are cost of sales and new merchandise development. Also, as previously noted, in order to grow retail sales, American Apparel will have to open new retail locations and hire additional retail personnel to service new retail stores, which will involve an increase in occupancy expense and payroll. In order to grow the wholesale distribution channel, American Apparel will have to hire new sales personnel to service new geographic territories.

To support new merchandise development, expenses will increase as American Apparel designs new products in existing and new categories.

Ongoing infrastructure investment also may be required to support growth. This may include expenditures for new buildings, machinery and equipment, upgraded information systems and additions to the Company's management team.

To reduce the impact of additional material expenses on earnings, American Apparel continues to look for ways to improve productivity of current manufacturing operations and to enhance other operating procedures. One of the initiatives already underway is the implementation of an enterprise resource planning (ERP) system that is expected to realize gains in operation efficiencies in a number of enterprise-wide processes including inventory and production management.

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American Apparel has developed a growth strategy that is designed to capitalize on its strengths. The principal elements of this growth strategy are:

### *Store Expansion*

The Company's growth strategy and the success of our business depends in part on the opening of new American Apparel retail stores, the renewal of existing store leases on terms that meet our financial targets, the remodeling of existing stores in a timely manner and the operation of these stores in a cost-efficient manner. American Apparel is committed to expanding its presence in the U.S. while significantly increasing its store footprint in markets throughout Europe and Asia. The Company expanded the store base by 78 net new stores in 2008. As of February 28, 2009, the Company has signed leases for an additional 9 store locations that the Company expects to open in 2009. American Apparel evaluates proposed sites based on traffic patterns, co-tenancies, average sales per square foot achieved by neighboring stores, lease economics, demographic characteristics and other factors considered important regarding the specific location. The Company's experience in international markets to date suggests that American Apparel's brand concept is readily transferable to new geographies.

### *New Merchandise Introduction*

As American Apparel expands beyond its original product offering of T-shirts, the Company is increasing the variety of products available to its growing customer base. American Apparel has strategically expanded its product offering to include denim, sweaters, jackets and other products and intends to continue to introduce new merchandise to complement its existing products and draw new customers.

### *Continue In-Sourcing Manufacturing Activities*

American Apparel has explored making strategic acquisitions to consolidate its manufacturing operations and continue to produce high quality products. In December 2007, the Company expanded operations into a new facility in South Gate, California where, commencing January 2008, it began cutting, sewing and garment dyeing a portion of its production. In May 2008, the Company acquired a fabric dyeing and finishing plant in Garden Grove, California, and has added knitting operations at that facility. American Apparel believes that bringing certain elements of its production process in-house affords the Company the opportunity to exert higher quality control while also lowering production costs. American Apparel intends to continue to pursue strategic opportunities to further consolidate its operations while maintaining production in the United States.

### *Enhance Information Systems Infrastructure*

The Company successfully completed the first phase of an enterprise resources planning ( ERP ) system in 2008. This first phase included the conversion of the Company's systems for manufacturing and warehouse operations, inventory management and control and wholesale operations. The improvements in operating information and control systems have represented a substantial improvement over the legacy systems. The Company has entered the second phase of the ERP implementation, which will include upgrading the financial accounting and control systems for the Company's U.S. operations. The second phase is scheduled to be completed in 2009. In conjunction with the implementation of this ERP system, the Company believes that a continued focus on enhancing its information systems infrastructure will further optimize operations.

## **Manufacturing Operations**

American Apparel conducts all of its manufacturing operations in the Los Angeles metropolitan area, and principally at its cutting and sewing facility in downtown Los Angeles, California. In January 2008, the Company began cutting, sewing, and garment dyeing a portion of its output in a new facility in South Gate, California which was acquired in December 2007. In May 2008, the Company acquired an additional facility in Garden Grove, California with cutting, dyeing and sewing capacity. Operations in this facility began in June 2008.

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American Apparel purchases yarn which is sent to knitters to be knit into greige fabric, which is fabric that is not dyed or processed. The Company currently conducts a portion of its knitting operations in-house at its knitting facilities in Los Angeles and Garden Grove, California. The Company operates circular and flat knitting machines, producing jersey, piqué, fleece and ribbing using cotton and cotton/polyester yarns. The Company also utilizes third-party commission knitters. The Company's knitting facilities knit approximately 80% of the total fabric used in American Apparel's garments, and employed a staff of approximately 100 people, as of December 31, 2008.

Knitted greige fabric produced at the Los Angeles and Garden Grove facilities or other commission knitters is batched for bleaching and dyeing and transported to the Company's dyeing and finishing facilities, or other commission dye houses. In some cases, dyed fabric is transferred to subcontractors for fabric laundering. The Company's dyeing and finishing facilities in the Los Angeles metropolitan area dye approximately 80% of the total fabric used in American Apparel's garments, and employed a staff of approximately 900 people, as of December 31, 2008.

Most fabric is shipped to the Company's primary manufacturing facility in downtown Los Angeles where it is inspected and then cut on manual and automated cutting tables, and subsequently sewn into finished garments. Some fabric is purchased directly from third parties, along with all trims. Garments are sewn by teams of sewing operators typically ranging from five to 15 operators, depending on the complexity of a particular garment. Each sewing operator performs a different sewing operation on a garment before passing it to the next operator. Sewing operators are compensated on a modified piece-rate basis. Quality control personnel inspect finished garments for defects and reject any defective product. American Apparel also manufactures some hosiery in-house at this facility, where it does knitting, inspection, and packing, and uses off-site contractors for washing and boarding. Approximately 3,900 employees were directly involved in the cutting, sewing, and hosiery operations at the downtown Los Angeles facility as of December 31, 2008.

American Apparel purchases yarn, certain fabrics and other raw materials from a variety of vendors over time. American Apparel does not have any major suppliers of raw materials that it relies on exclusively to support its production operations. The inputs that American Apparel uses are produced competitively by a large number of potential suppliers. Since the inputs are commodity in nature, American Apparel believes that it could easily source its inputs from other vendors if its current suppliers were not able to meet its needs.

American Apparel maintains two warehouses, in addition to a warehouse and distribution center at its downtown Los Angeles facility, in the Los Angeles metropolitan area, where it stores fabric rolls, trims, and finished goods. The Company also maintains warehouses in Montreal, Quebec and Neuss, Germany.

## **Retail**

As of December 31, 2008, the Company's retail operations consisted of 260 retail stores in 19 countries, including the United States, Canada, Mexico, Brazil, United Kingdom, Austria, Belgium, Germany, France, Italy, the Netherlands, Spain, Sweden, Switzerland, Israel, Australia, Japan, South Korea and China. American Apparel opened its first retail location in October 2003, in the Echo Park neighborhood of Los Angeles, California. American Apparel's retail operations principally target young adults aged 20 to 32 through its unique assortment of fashionable clothing and accessories and its compelling in-store experience. American Apparel has established a reputation with its customers, who are culturally sophisticated, creative, and independent-minded. The product offering includes women's and men's basic apparel and accessories, as well as new lines for children and pets. Stores average approximately 2,500-3,000 square feet of selling space. American Apparel's stores are located in large metropolitan areas, emerging neighborhoods, and select university communities.

American Apparel seeks to instill enthusiasm and dedication in store management personnel and sales associates through regular communication with the stores. Store personnel receive minimum hourly compensation and receive discretionary incentive compensation based on meeting sales and profitability benchmarks.

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### **Wholesale**

The Company's wholesale operations sell to over a dozen authorized distributors and approximately 10,000 screen printers and advertising specialty companies. These screen printers and advertising specialty companies decorate our blank product with corporate logos, brands and other images. American Apparel's wholesale customers sell imprinted sportswear and accessories to a highly diversified range of end-consumers, including corporations, sporting venues, concert promoters, athletic leagues, and educational institutions, among others. In order to better serve customers, American Apparel allows customers to order products by the piece, by the dozen, or in full case quantities. American Apparel also, to a lesser extent, fulfills custom and private-label orders. American Apparel does not have any major customers that account for ten percent or more of total consolidated net sales.

To serve its wholesale customers, American Apparel operates a call center out of its Los Angeles headquarters. The call center is staffed with approximately 50 customer service representatives initiating sales calls, answering incoming phone calls, emails, and faxes, assisting customers in placing orders, checking stock levels, looking for price quotes or requesting adjustments. On average, the call center receives 800 calls daily and operates from Monday to Friday, 7am to 6pm, Pacific Time ( PT ).

While American Apparel operates primarily on a make-to-stock basis, manufacturing and maintaining a sufficient inventory of products to meet demand, the Company's in-house manufacturing capacity also allows American Apparel to fulfill large orders in a timely fashion. American Apparel capitalizes on its inventory position by providing a quick turn-around on customer orders. Credit approved orders to be shipped by ground service are generally shipped the same day when received before 4:30pm PT while those to be shipped by air are generally shipped the same day when received by 3:30pm PT. The majority of American Apparel's wholesale and internet consumer orders are processed within these parameters. For these reasons, American Apparel does not typically maintain a large backlog of orders.

### **Online Consumer Sales**

Since 2004, American Apparel has operated an online consumer e-commerce website, which offers the Company's products for purchase. This e-commerce website, located at [www.americanapparel.com](http://www.americanapparel.com), has localized storefronts for the United States, Canada, the United Kingdom, Continental Europe, Switzerland, Japan, Korea, and Australia. For segment reporting purposes U.S. online sales are included in the U.S. Wholesale business segment. Canada online sales are included in the Canada business segment, and overseas online retail sales are included in the International business segment.

### **Brand, Advertising, and Marketing**

American Apparel's advertising and direct marketing initiatives have been developed to elevate brand awareness, facilitate customer acquisition and retention and support key growth strategies. American Apparel's in-house creative team works to create edgy, high-impact, provocative ads which are produced year-round and are featured in leading national and local lifestyle publications, on billboards, and on specialty online websites. American Apparel maintains a photo studio at its headquarters. Content for American Apparel's website and online store are also generated internally at American Apparel. While the primary intent of this advertising is to support American Apparel's retail and online e-commerce operations, the wholesale business also benefits from the greater overall brand awareness generated by this advertising.

For its wholesale operations, American Apparel utilizes industry trade shows to expand and enhance customer relationships, exhibit its product offerings and share new promotions with customers. American Apparel participates in approximately two dozen trade shows annually. American Apparel also produces print catalogs of its wholesale products, designed to be of the standard of high-end consumer retail catalogs with attractive models, appealing photographs and a clear display of products.

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### **Product Development**

American Apparel employs an in-house staff of designers and creative professionals to develop updated versions of timeless, iconic styles. Led by Dov Charney, this team takes its inspiration from classic styles of the past, as well as the latest emerging fashion trends. American Apparel's design team will often continue to update or renew a style long after its launch.

### **Intellectual Property**

American Apparel trademarks and service marks, and certain other trademarks, have been registered, or are the subject of pending trademark applications with the United States Patent and Trademark Office and with the registries of many foreign countries and/or are protected by common law. In the United States, American Apparel is the registered owner of the American Apparel®, Classic Girl®, Standard American®, Classic Baby®, and Sustainable Edition® trademarks, among others.

### **Competition**

The specialty retail, online retail and wholesale apparel businesses are each highly competitive. The apparel industry is characterized by rapid shifts in fashion, consumer demand, and competitive pressures, resulting in both price and demand volatility. American Apparel believes that its emphasis on quality fashion essentials mitigates these factors.

American Apparel's retail operations compete on the basis of the location of the stores, the breadth, quality, style, and availability of merchandise, the level of customer service offered, and the price of goods of similar brand name quality. While American Apparel believes that the fit and quality of its garments, as well as the broad variety of colors and styles of casual fashion essentials that it offers, helps differentiate it, it competes against a wide variety of smaller, independent specialty stores, as well as department stores and national and international specialty chains. Companies that operate in this space include The Gap, Urban Outfitters, H&M, Uniqlo and Forever 21. Many of these companies have substantially greater name recognition than American Apparel. Many of these companies also have greater financial, marketing, and other resources when compared to American Apparel.

The wholesale business competes with numerous wholesale companies based on the quality, fashion, availability, and price of our wholesale product offering. These companies include Gildan Activewear, Hanesbrands, Russell Athletic and Fruit of the Loom. Many of these companies have greater name recognition than American Apparel in the wholesale market. Many of these companies also have greater financial and other resources when compared to American Apparel.

Along with the competitive factors noted above, other key competitive factors for American Apparel's online e-commerce operations include the success or effectiveness of customer mailing lists, advertising response rates, merchandise delivery, web site design and web site availability. The online e-commerce operations compete against numerous web sites, many of which may have a greater volume of web traffic, and greater financial, marketing, and other resources.

### **Seasonality**

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

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### **Employees**

As of December 31, 2008, American Apparel employed a work force of approximately 9,700 employees worldwide. To ensure the Company's long-term success, American Apparel must attract, hire, develop, and retain skilled manufacturing, retail, sales, creative, and administrative employees, as well as executives. Competition for such employees can be intense.

American Apparel views its employees as long-term investments and adheres to a philosophy of providing employees with decent working conditions in a technology-driven environment which allows the Company to attain improved efficiency, while promoting employee loyalty. American Apparel provides a compensation structure and benefits package for manufacturing employees that includes above-market wages, company-subsidized health insurance, free English language classes, free massage, free parking, as well as other benefits. American Apparel also provides for a well-lit working environment that is properly ventilated and heated or cooled in its manufacturing facilities. These working conditions, as well as compensation and benefits packages, are key elements in achieving American Apparel's desire to be an employer of choice in the Los Angeles area. None of the Company's employees are covered by a collective bargaining agreement. American Apparel has never had a strike and believes that its relations with its employees are excellent. The Company makes diligent efforts to comply with all employment and labor regulations, including immigration laws, in the many jurisdictions in which the Company conducts operations.

### **Information Technology**

American Apparel is committed to utilizing technology to enhance its competitive position. American Apparel's information systems provide data for production, merchandising, distribution, retail stores and financial systems. The core business systems, which consist of both purchased and internally developed software, are accessed over a company-wide network providing corporate employees with access to key business applications. American Apparel dedicates a significant portion of its information technology resources to web services, which includes the operation of the corporate website at [www.americanapparel.net](http://www.americanapparel.net) and the online retail site at [www.americanapparel.com](http://www.americanapparel.com).

To support continued growth, American Apparel has initiated a strategic review of its information systems. American Apparel is in the process of implementing an ERP system to replace, enhance and integrate many elements of its current information systems. American Apparel currently operates a number of unrelated information technology systems that have resulted in operational inefficiencies and in some cases have increased costs. Implementation of the new ERP system is a multi-phased project with the first phase, covering manufacturing and production planning, having been completed in 2008, and the second phase, covering the financial accounting and control systems of the Company's U.S. operations, expected to be completed in 2009.

### **Environmental Regulation**

American Apparel's operations are subject to various environmental and occupational health and safety laws and regulations. Because the Company monitors, controls and manages environmental issues, American Apparel believes it is in compliance in all material respects with the regulatory requirements of those jurisdictions in which its facilities are located. In line with its commitment to the environment as well as to the health and safety of its employees, American Apparel will continue to make expenditures to comply with these requirements, and does not believe that compliance will have a material adverse effect on its business.



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**Available Information**

We will make available on our website, *www.americanapparel.net*, under Investor Relations free of charge, our annual reports on Form 10-K, as well as the latest quarterly reports on Form 10-Q, the latest reports on Form 8-K, the latest proxy statements and amendments to those documents as soon as reasonably practicable after we electronically file or furnish such materials to the SEC. You can also obtain copies of these materials at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You can obtain information on the operation of the public reference facilities by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website at *www.sec.gov* that makes available reports, proxy statements and other information regarding American Apparel that we file electronically with it. By referring to our corporate website, *www.americanapparel.net*, and our online retail website, *www.americanapparel.com*, we do not incorporate these websites or their contents into this Form 10-K.

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***Purchases of retail apparel merchandise are generally discretionary and economic conditions may cause a decline in consumer spending which could adversely affect our business and financial performance.***

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

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

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

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

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

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

***American Apparel has significant indebtedness and a failure to generate significant cash flow could render it unable to service its obligations and may place it at a competitive disadvantage and limit its ability to pursue its expansion plans.***

As of March 13, 2009, American Apparel has substantial indebtedness, including \$32.8 million of borrowings under its revolving credit facility and \$80 million of borrowings under its facility with Lion (as defined below). The borrowings under its revolving credit facility bear interest at LIBOR plus 4.5% per annum, or prime rate (which rate can in no event be lower than LIBOR plus 2.5% per annum) plus 2.5% per annum, at the Company's option, and the borrowings under its facility with Lion Capital LLP bear interest at 15% per annum (excluding debt discount), payable quarterly in arrears, in each case plus an additional 2% per annum if we are in default under such facility. American Apparel's ability to service this indebtedness is dependent on its ability to generate cash from internal operations sufficient to make required payments on such indebtedness. Our level of indebtedness has important consequences to you and your investment in our common stock. For example, our level of indebtedness may:

require us to dedicate a substantial portion of our cash flow from operations to pay interest and principal on our debt, which would reduce the funds available to use for operations, investments, future business opportunities and other general corporate purposes;

make it more difficult for us to satisfy our debt obligations, and any failure to comply with such obligations, including financial and other restrictive covenants, could result in an event of default under the agreements governing such indebtedness, which could lead to, among other things, an acceleration of our indebtedness or foreclosure on the assets securing our indebtedness, which could have a material adverse effect on our business or financial condition;

limit our ability to obtain additional financing, or to sell assets to raise funds, if needed, for working capital, capital expenditures, expansion plans and other investments, which may limit our ability to implement our business strategy;

result in higher interest expense if interest rates increase on our floating rate borrowings;

heighten our vulnerability to downturns in our business, the industry or in the general economy and limit our flexibility in planning for or reacting to changes in our business and the retail industry; or

reduce our ability to make acquisitions or take advantage of business opportunities as they arise or successfully carry out our plans to expand our store base, product offerings and sales channels.

In addition, the terms of our indebtedness contain, and our future indebtedness may contain, various restrictive covenants that limit our management's discretion in operating our business, including limitations on



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capital expenditures. See The terms of our indebtedness contain various covenants that may limit our business activities below.

It is uncommon for companies involved in the retail apparel business to operate with such a high level of indebtedness due to the underlying volatility of this business. Despite the attendant risks, American Apparel may have to enter into new credit facilities, or possibly issue additional common stock, to finance its planned retail expansion. There can be no assurances that American Apparel will have access to any such financing on commercially reasonable terms or that it will be able to open its planned number of new stores in 2009 or beyond.

*If we are unable to gauge fashion trends and react to changing consumer preferences in a timely manner, our sales will decrease.*

Our success is largely dependent upon our ability to gauge the fashion tastes of our customers and to provide merchandise that satisfies customer demand in a timely manner. The retail apparel business fluctuates according to changes in consumer preferences dictated, in part, by fashion and season. To the extent we misjudge the market for our merchandise or the products suitable for our market, our sales will be adversely affected. Some of our past product offerings have not been well received by our customer base. Merchandise misjudgments could have a material adverse effect on our image with our customers and on our operating results. Fluctuations in the apparel retail market affect the inventory owned by apparel retailers, since merchandise usually must be manufactured in advance of the season and frequently before fashion trends are evidenced by customer purchases. In addition, the cyclical nature of the retail apparel business requires us to carry a significant amount of inventory, especially prior to peak selling seasons when we build up our inventory levels. As a result, we will be vulnerable to demand and pricing shifts and to suboptimal selection and timing of merchandise production. If sales do not meet expectations, too much inventory may lower planned margins. Our brand image may also suffer if customers believe we are no longer able to offer the latest fashion. The occurrence of these events could adversely affect our financial results by decreasing sales.

*We operate in the highly competitive retail industry and our market share may be adversely impacted at any time by the significant number of competitors in our industry that may compete more effectively than we can.*

The apparel industry is characterized by rapid shifts in fashion, consumer demand and competitive pressures, resulting in both price and demand volatility. The retail apparel industry, in general, and the imprintable apparel market, specifically, are fragmented and highly competitive. Prices of certain products we manufacture, particularly T-shirts, are determined based on market conditions, including the price of raw materials. There can be no assurance that we will be able to compete successfully in the future. We compete with national and local department stores, specialty and discount store chains, independent retail stores and Internet businesses that market similar lines of merchandise, including The Gap, Urban Outfitters, H&M, Uniqlo and Forever 21. Many of our competitors are, and many of our potential competitors may be, larger, have substantially greater name recognition than American Apparel and have greater financial, marketing and other resources and, therefore, may be able to adapt to changes in customer requirements more quickly, devote greater resources to the marketing and sale of their products, generate greater national brand recognition or adopt more aggressive pricing policies than we can. We face a variety of competitive challenges, including:

anticipating and quickly responding to changing consumer demands;

maintaining favorable brand recognition and effectively marketing our products to consumers in diverse markets;

developing innovative, high-quality products in sizes, colors and styles that appeal to consumers;

sourcing raw materials and manufacturing merchandise efficiently;

pricing our products to remain competitive while achieving a customer perception of comparatively higher value;

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providing strong and effective marketing support; and

maintaining high levels of consumer traffic to our retail stores.

We also face competition in European, Asian and Canadian markets from established regional and national chains. Our success in these markets depends on determining a sustainable profit formula to build brand loyalty and gain market share in these challenging retail environments. If our international business is not successful or if we cannot effectively take advantage of international growth opportunities, our results of operations could be adversely affected.

The wholesale business competes with numerous wholesale companies based on the quality, fashion, availability, and price of our wholesale product offerings. These companies include Gildan Activewear, Hanesbrands, Russell Athletic and Fruit of the Loom. Many of these companies have greater name recognition than American Apparel in the wholesale market. Many of these companies also have greater financial and other resources when compared to American Apparel. If we cannot successfully compete with these companies, our results of operations could be adversely affected.

***We depend on key personnel, and our ability to grow and compete will be harmed if we do not retain the continued services of such personnel, or we fail to identify, hire and retain additional qualified personnel.***

We depend on the efforts and skills of American Apparel's management team, and the loss of services of one or more members of this team, each of whom have substantial experience in the apparel industry, could have an adverse effect on our business. American Apparel's senior officers closely supervise all aspects of the American Apparel business, in particular the design and production of merchandise and the operation of the American Apparel stores. Because American Apparel had never operated as a public company prior to the Acquisition, the Company needs to enhance its management team, including those responsible over financial reporting, to address reporting requirements that come with being a public company. If we are unable to hire and retain qualified management or if any member of American Apparel's management leaves, such departure could have an adverse effect on our operations and could adversely affect our ability to design new products and to maintain and grow the distribution channels for our products. In particular, we believe we have benefited substantially from the leadership and strategic guidance of Dov Charney. The loss of Dov Charney would be particularly harmful as he is considered intimately connected to American Apparel's brand identity and is the principal driving force behind American Apparel's core concepts and designs. He is also the driving force behind our growth strategy.

Our ability to anticipate and effectively respond to changing fashion trends depends in part on our ability to attract and retain key personnel in our design, merchandising and marketing areas, and other functions. In addition, if we experience material growth, we will need to attract and retain additional qualified personnel. The market for qualified and talented design and marketing personnel in the apparel industry is intensely competitive, and we cannot be sure that we will be able to attract and retain a sufficient number of qualified personnel in future periods. If we are unable to attract or retain qualified personnel as needed, our growth will be hampered and our operating results could be materially adversely affected.

***We rely heavily on immigrant labor, and changes in immigration laws or enforcement actions or investigations under such laws could significantly adversely affect our labor force, manufacturing capabilities, operations and financial results.***

We rely heavily on immigrant labor. Adverse changes to existing laws and regulations applicable to employment of immigrants, enforcement requirements or practices under those laws and regulations, and inspections or investigations by immigration authorities or the prospects or rumors of any of the foregoing, even if no violations exist, could negatively impact the availability and cost of personnel and labor to American Apparel. In late 2007, American Apparel received a notice from the Immigration and Customs Enforcement division of the U.S. Department of Homeland Security (ICE) requesting to inspect the I-9 forms of the employees of American Apparel, Inc. In January 2008, American Apparel provided ICE with access to the

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requested forms. American Apparel has not had any further communications with ICE since this request was fulfilled. If ICE officials find violations of immigration laws, they may take a variety of actions, including requesting additional information, issuing fines or warning notices, obtaining warrants and conducting a search of the workplace, requiring termination of certain employees or filing criminal charges. As a result of the ICE investigation, even if no violations are found, American Apparel could experience very substantial turnover of employees on short or no notice, which could result in manufacturing and other delays. American Apparel also may also have difficulty attracting or hiring new employees in a timely manner, resulting in further delays. These delays could materially adversely affect our revenues and ability to compete. If American Apparel is not able to continue to attract and retain sufficient employees, American Apparel's manufacturing capabilities, operations and financial results would be adversely affected.

***Our growth strategy relies in part on the opening of new stores and the remodeling of existing stores periodically which may strain our resources and adversely impact the performance of our existing store base.***

We expanded our store base by 78 net new stores in fiscal 2008. As of February 28, 2009, we have signed leases for an additional 9 store locations that we expect to open in 2009. Our growth strategy and the success of our business depends in part on the opening of new American Apparel retail stores, the renewal of existing store leases on terms that meet our financial targets, the remodeling of existing stores in a timely manner and the operation of these stores in a cost-efficient manner. Successful implementation of this portion of our growth strategy depends on a number of factors including, but not limited to, our ability to:

identify and obtain suitable store locations and negotiate acceptable leases for these locations;

complete store design and remodeling projects on time and on budget;

manage and expand our infrastructure to accommodate growth;

generate sufficient operating cash flows or secure adequate capital on commercially reasonable terms to fund our expansion plan and remain in compliance with the capital expenditure covenant and other relevant covenants in our credit facilities that may limit our ability to fund such expansion plans;

manage inventory effectively to meet the needs of new and existing stores on a timely basis;

foster current relationships and develop new relationships with vendors that are capable of supplying a greater volume of merchandise;

avoid construction delays and cost overruns in connection with the build-out of new stores;

supply our stores with proper types and quantities of merchandise; and

hire, train and retain qualified store managers and sales people.

Our plans to expand our store base and to remodel certain existing stores may not be successful and the implementation of these plans may not result in an increase in our revenues even though they increase our costs. Additionally, new stores that we open may place increased demands on our existing financial, operational, managerial and administrative resources, which could cause us to operate less effectively.

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Furthermore, it is possible that by opening a new store in an existing market, we could adversely affect the previously existing stores in that market by drawing away traffic from the previously existing stores. Our new stores may not be immediately profitable and, as such, we may incur losses until these stores become profitable. Any failure to successfully open and operate new stores would adversely affect our results of operations.

*The market for real estate in desirable retail store locations is competitive, which could hamper our ability to open new stores.*

Our ability to obtain real estate to open new stores in desirable locations depends upon the availability of real estate that meets our criteria, which includes, among other items, projected foot traffic, square footage,



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demographics and whether we are able to negotiate lease terms that meet our operating budget. In addition, we must be able to effectively renew our existing store leases from time to time. Failure to secure real estate in desirable locations on economically beneficial terms or to renew leases on existing store locations on economically beneficial terms could have a material adverse effect on our results of operations.

***Our plans to expand our product offerings and sales channels may not be successful, and implementation of these plans may divert our operational, managerial and administrative resources, which could impact our competitive position.***

Our ability to grow our existing brand and develop or identify new growth opportunities depends in part on our ability to appropriately identify, develop and effectively execute strategies and initiatives. Failure to effectively identify, develop and execute strategies and initiatives may lead to increased operating costs without offsetting benefits and could have a material adverse effect on our results of operations. These plans involve various risks discussed elsewhere in these risk factors, including:

implementation of these plans may be delayed or may not be successful;

if our expanded product offerings and sales channels fail to maintain and enhance our distinctive brand identity, our brand image may be diminished and our sales may decrease;

if we fail to expand our infrastructure, including by securing desirable store locations at reasonable costs and hiring and training qualified employees, we may be unable to manage our expansion successfully; and

implementation of these plans may divert management's attention from other aspects of our business and place a strain on our management, operational and financial resources, as well as our information systems.

In addition, our ability to successfully carry out our plans to expand our product offerings and our sales channels may be affected by, among other things, economic and competitive conditions, changes in consumer spending patterns and changes in consumer preferences and fashion trends. Our expansion plans could be delayed or abandoned, could cost more than anticipated and could divert resources from other areas of our business; any of which could impact our competitive position and reduce our revenue and profitability.

***Expanding our business internationally is an important part of our overall growth strategy and our success in this regard is subject to numerous risks, any of which could delay or prevent successful penetration into international markets.***

As we expand internationally, we need to effectively and efficiently open and operate stores in international locations. Our international growth will be limited unless we can:

identify suitable markets and obtain suitable sites for store locations;

negotiate acceptable lease terms;

complete store design and remodeling projects on time and on budget;

hire, train and retain competent store personnel;

gain acceptance from foreign customers;

manage inventory effectively to meet the needs of new and existing stores on a timely basis;

manage and expand infrastructure to accommodate growth;

generate sufficient operating cash flows or secure adequate capital on commercially reasonable terms to fund our expansion plan;

manage foreign exchange risks effectively;

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address existing and changing legal, regulatory and political environments in target foreign markets; and

manage international growth, if any, in a manner that does not unduly strain our financial, operating and management resources. We anticipate that we will incur significant costs related to starting up and maintaining additional foreign operations. Costs may include, and will not be limited to, obtaining prime locations for stores, setting up foreign offices and distribution facilities and hiring experienced management. These increased demands may cause the Company to operate its business less effectively, which in turn could cause deterioration in the performance of its stores. Furthermore, the Company's ability to conduct business in international markets may be affected by legal, regulatory, political and economic risks.

***If we fail to maintain the value and image of our brand, our sales are likely to decline.***

Our success depends on the value and image of the American Apparel brand. The American Apparel name is integral to our business as well as to the implementation of our strategies for expanding our business. Maintaining, promoting and positioning our brand depend largely on the success of our marketing and merchandising efforts and our ability to provide a consistent, high quality customer experience. Our brand could be adversely affected if we fail to achieve these objectives or if our public image or reputation or those of our senior personnel were to be tarnished by negative publicity. Any of these events could result in decreases in sales.

***We expect to experience fluctuations in our comparable store sales and margins, which could cause our earnings to decline and make it difficult to gauge our growth at any specific period of time.***

Our inability to maintain recent levels of comparable store sales could cause our earnings to decline. Our success depends, in part, upon our ability to improve sales, as well as gross margins and operating margins, at American Apparel's existing stores. American Apparel's comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that they will continue to fluctuate in the future. A variety of factors affect comparable store sales, including fashion trends, competition, current economic conditions, pricing, inflation, the timing of release of new merchandise and promotional events, changes in our merchandise mix, the success of marketing programs, timing and level of markdowns and weather conditions. These factors may cause our comparable store sales results to differ materially from prior periods and from our expectations, which could cause a decrease in our earnings. Our ability to deliver strong comparable store sales results and margins depends in large part on accurately forecasting demand and fashion trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our customer base, managing inventory effectively, using more effective pricing strategies, and optimizing store performance.

***Our failure to adequately protect our trademarks and other intellectual property rights could diminish the value of our brand and reduce demand for our merchandise.***

American Apparel trademarks and service marks, and certain other trademarks, have been registered, or are the subject of pending trademark applications with the United States Patent and Trademark Office and with the registries of many foreign countries and/or are protected by common law. In the United States, American Apparel is the registered owner of the American Apparel®, Classic Girl®, Standard American®, Classic Baby®, and Sustainable Edit® trademarks, among others. The Company's products are noted for their quality and fit, and the Company's edgy, distinctive branding has differentiated it in the marketplace. As such, the trademark and variations thereon are valuable assets that are critical to our success. We intend to continue to vigorously protect our trademark and brand against infringement, but we may not be successful in doing so. In addition, the laws of certain foreign countries may not protect proprietary rights to the same extent as do the laws of the United States. The unauthorized reproduction or other misappropriation of our trademark would diminish the value of our brand, which could reduce demand for our products or the prices at which we can sell our products.

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***Our ability to attract customers to our stores depends heavily on the success of the shopping areas in which they are located.***

In order to generate customer traffic, the Company locates many of its stores in prominent locations within successful shopping areas. Net sales at these stores partly dependent on the volume of traffic in those shopping areas. Our stores benefit from the ability of a shopping area's other tenants to generate consumer traffic in the vicinity of our stores and the continuing popularity of the shopping areas. The Company cannot control the availability or cost of appropriate locations within existing or new shopping areas, competition with other retailers for prominent locations or the success of individual shopping areas. In addition, factors beyond the Company's control impact shopping area traffic, such as economic conditions nationally or in a particular area, competition from internet retailers, changes in consumer demographics in a particular market, the closing or decline in popularity of other stores in the shopping areas where our stores are located, deterioration in the financial conditions of the operators of the shopping areas or developers and consumer spending levels. The slowdown in the U.S. economy has negatively affected consumer spending and reduced shopping area traffic. A significant decrease in shopping area traffic could have a material adverse effect on the Company's financial condition or results of operations. Furthermore, in pursuing its growth strategy, the Company will be competing with other retailers for prominent locations within the same successful shopping areas. If the Company is unable to secure these locations or is unable to renew store leases on acceptable terms as they expire from time-to-time it may not be able to continue to attract the number or quality of customers it normally has attracted or would need to attract to sustain its projected growth. All these factors may also impact the Company's ability to meet its growth targets and could have a material adverse effect on its financial condition or results of operations.

***Fluctuations in our results of operations from quarter to quarter could have a disproportionate effect on our overall financial condition and results of operations.***

We experience seasonal fluctuations in revenues and operating income. Historically, sales during the second and third fiscal quarters have generally been the highest, with sales during the first fiscal quarter being the lowest. Any factors that harm our operating results for the second and third fiscal quarters, including adverse weather or unfavorable economic conditions, could have a disproportionate effect on our results of operations for the entire fiscal year.

In order to prepare for our peak selling season, we must produce and keep in stock more merchandise than we would carry at other times of the year. Any unanticipated decrease in demand for our products during our peak selling season could require us to sell excess inventory at a substantial markdown, which could reduce our net sales and gross profit.

***The terms of our indebtedness contain various covenants that may limit our business activities.***

The terms of our indebtedness contain, and our future indebtedness may contain, various restrictive covenants that limit our management's discretion in operating our business. In particular, these agreements include, or may include, covenants relating to limitations on:

dividends on, and redemptions and repurchases of, capital stock;

payments on subordinated debt;

liens and sale-leaseback transactions;

loans and investments;

debt and hedging arrangements;

mergers, acquisitions and asset sales;

transactions with affiliates;

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disposals of assets;

changes in business activities conducted by us and our subsidiaries; and

capital expenditures, including to fund future store openings.

In addition, our indebtedness requires us to comply with certain financial ratios and maintain certain amounts of unused availability under our revolving credit facility. Such restrictions could limit American Apparel's ability to respond to market conditions, to provide for unanticipated capital investments or to take advantage of business or acquisition opportunities. See Risk Factors Failure of American Apparel to remain in compliance with certain financial covenants under its financing arrangements could result in the acceleration of its debt payment obligations. Also see Management's Discussion and Analysis of Financial Condition and Results of Operations Debt Agreements .

Compliance with these covenants and these ratios may prevent us from pursuing opportunities that we believe would benefit our business, including opportunities that we might pursue as part of our plans to expand our store base, our product offerings and sales channels.

***Failure of American Apparel to remain in compliance with certain financial covenants under its financing arrangements could result in the acceleration of its debt repayment obligations.***

The financing agreements between American Apparel and its lenders contain certain financial covenants relating to American Apparel's capital expenditure limitations, availability under its revolving credit facility and debt to EBITDA ratios. Failure of American Apparel to maintain compliance with any of these financial covenants can result in American Apparel being unable to borrow under its revolving credit facility, which it utilizes to access its working capital, and may adversely affect the ability of American Apparel to finance and continue its operations. Such a failure could also result in an increase in the interest rate payable under the financing arrangements and acceleration of the outstanding debt in its entirety, and may adversely affect the ability of American Apparel to obtain financing that may be necessary to effectively operate its business and grow the business going forward.

***Substantially all of our assets are used to secure our credit facilities, certain term loans and equipment leasing agreements.***

Our credit facilities are secured by substantially all assets of the Company including cash, inventory and accounts receivable, and our second lien term loan facility is also secured by substantially all assets of the Company. All leasing agreements are secured by equipment provided by the leasing arrangement. In the event of a default on these agreements, substantially all of the assets of American Apparel could be subject to liquidation by the creditors, which liquidation could result in no assets being left for the stockholders after the creditors receive their required payment.

***Cost increases in the materials or labor used to manufacture our products could negatively impact our business and financial condition.***

The manufacture of American Apparel's products is labor intensive and utilizes raw materials supplied by third parties. An important part of American Apparel's branding and marketing is that its products are made in the United States. The Federal Trade Commission has stated that for a product to be called "Made in USA", or claimed to be of domestic origin without qualifications or limits on the claim, the product must be "all or virtually all" made in the U.S. The term "United States" includes the 50 states, the District of Columbia, and the U.S. territories and possessions. "All or virtually all" means that all significant parts and processing that go into the product must be of U.S. origin. That is, the product should contain no - or negligible - foreign content. American Apparel meets the FTC's "Made in USA" standard and from the knitting process to the final sewing of a garment, all of the processes are conducted in the U.S., either directly by American Apparel in its knitting,

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manufacturing, dyeing and finishing facilities located in Los Angeles or through commission knitters, dyers and sewers in the Los Angeles metropolitan area and other regions in the U.S. If the cost of labor materially increases, our financial results could be materially adversely affected and our ability to compete against companies with lower labor costs could be hampered. Material increases in labor costs in the United States could also force us to move all or a portion of our manufacturing overseas, which could adversely affect the American Apparel brand identity. Similarly, increases in the prices we pay to the suppliers of the raw materials used in the manufacturing of our products could adversely affect our financial condition and ability to compete and could force us to seek to offset increased raw material costs by relocating all or a portion of our manufacturing overseas to locations with lower labor costs.

### ***Unionization of employees at our facilities could result in increased risk of work stoppages and high labor costs.***

American Apparel's employees are not party to any collective bargaining agreement or union. If employees at our manufacturing or distribution facilities were to unionize, our relationship with our employees could be adversely affected. We would also face an increased risk of work stoppages and higher labor costs. Accordingly, unionization of our employees could have a material adverse impact on our operating costs and financial condition and could force us to raise prices on our products, curtail operations and/or relocate all or a portion of our operations overseas.

### ***We are subject to customs, advertising, consumer protection, zoning and occupancy and labor and employment laws that could require us to modify our current business practices and incur increased costs.***

We are subject to numerous regulations, including customs, truth-in-advertising, consumer protection and zoning and occupancy laws and ordinances that regulate retailers generally and/or govern the importation, promotion and sale of merchandise and the operation of retail stores and warehouse facilities. We also are subject to numerous federal and state labor laws, such as minimum wage laws and other laws relating to employee benefits. If these regulations were to change or were violated by our management, employees, suppliers, buying agents or trading companies, the costs of certain goods could increase, or we could experience delays in shipments of our goods, be subject to fines or penalties, or suffer reputational harm, which could reduce demand for our merchandise and hurt our business and results of operations. In addition, changes in federal and state minimum wage laws and other laws relating to employee benefits could cause us to incur additional wage and benefits costs, which could adversely affect our profitability.

Legal requirements are frequently changed and subject to interpretation, and we are unable to predict the ultimate cost of compliance with these requirements or their effect on our operations. We may be required to make significant expenditures or modify our business practices to comply with existing or future laws and regulations, which may increase our costs and materially limit our ability to operate our business.

### ***Current environmental laws, or laws enacted in the future, may harm our business.***

We are subject to federal, state and local laws, regulations and ordinances that govern activities or operations that may have adverse environmental effects (such as emissions to air, discharges to water, and the generation, handling, storage and disposal of solid and hazardous wastes). We are also subject to laws, regulations and ordinances that impose liability for the costs of clean up or other remediation of contaminated property, including damages from spills, disposals or other releases of hazardous substances or wastes, in certain circumstances without regard to fault. Certain of our operations routinely involve the handling of chemicals and wastes, some of which are or may become regulated as hazardous substances. Our product design and procurement operations must comply with new and future requirements relating to the materials composition of our products. If we fail to comply with the rules and regulations regarding the use and sale of such regulated substances, we could be subject to liability. The costs and timing of costs under environmental laws are difficult to predict.

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As is the case with manufacturers in general, if a release of hazardous substances occurs on or from its properties or any associated offsite disposal locations, or if contamination from prior activities is discovered at any of its properties, American Apparel may be held liable. The amount of such liability could be material.

***Our manufacturing operations are located and will be located in higher-cost geographic locations, placing us at a possible disadvantage to competitors that have a higher percentage of their manufacturing operations overseas.***

Despite the general industry-wide migration of manufacturing operations to lower-cost locations, such as Central America, the Caribbean Basin and Asia, American Apparel's textile manufacturing operations are still located in the United States, which is a higher-cost location relative to these offshore locations. In addition, American Apparel's competitors generally source or produce a greater portion of their textiles from regions with lower costs than American Apparel, which also places us at a cost disadvantage. Our competitor's lower costs of production may allow them to offer their products at a lower price than American Apparel's selling prices for similar products. This could force American Apparel to lower its margins or to compete more vigorously with non-price competitive strategies to preserve the Company's margins and sales volume.

***Our reliance on operational facilities located in the same vicinity makes our business susceptible to disruptions or adverse conditions affecting the location of our facilities.***

American Apparel conducts all of its manufacturing operations in the Los Angeles metropolitan area. Specifically, it operates principally out of its 800,000 square foot facility in downtown Los Angeles, which houses its executive offices, as well as its cutting, sewing, and distribution operations. The Company also operates a knitting facility in Los Angeles, California; a sewing, garment dyeing and finishing facility in South Gate, California; two fabric dyeing and finishing facility in each of Hawthorne, California and Garden Grove, California; as well as a warehouse facility in Commerce, California and Los Angeles, California. As a result, the Company's operations are susceptible to local and regional factors, such as accidents, system failures, economic and weather conditions, natural disasters, and demographic and population changes, as well as other unforeseen events and circumstances. Southern California is particularly susceptible to earthquakes. Any significant interruption in the operation of any of these facilities could reduce our ability to receive and process orders and provide products and services to our stores and customers, which could result in lost sales, cancelled sales and a loss of loyalty to our brand. Furthermore, if there were a major earthquake, we may have to cease operations for a significant portion of time due to damages to our factory and the inability to deliver products to our distribution centers.

***Third party failure to deliver merchandise to stores and customers could result in lost sales or reduced demand for our merchandise.***

The efficient operation of American Apparel's stores and wholesale business depends on the timely receipt of merchandise from its distribution centers. Independent third party transportation companies deliver a substantial portion of American Apparel's merchandise to our stores. These shippers may not continue to ship our products at current pricing or terms. These shippers may employ personnel represented by labor unions. Disruptions in the delivery of merchandise or work stoppages by employees or contractors of these third parties could delay the timely receipt of merchandise, which could result in cancelled sales, a loss of loyalty to our brand and excess inventory. There can be no assurance that such stoppages or disruptions will not occur in the future. Any failure by these third parties to respond adequately to our distribution needs would disrupt our operations and could have a material adverse effect on our financial condition and results of operations.

Timely receipt of merchandise by our stores and our customers may also be affected by factors such as inclement weather, natural disasters and acts of terrorism. We may respond by increasing markdowns or initiating marketing promotions, which would decrease our gross profits and net income.



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*Elimination or scaling back of U.S. import protections would weaken an important barrier to the entry of foreign competitors who produce their merchandise in lower labor cost locations. This could place us at a disadvantage to those competitors.*

Our products are subject to foreign competition. Foreign producers of apparel often have significant labor cost advantages, which can enable them to sell their products at relatively lower prices. However, in the past, foreign competitors have been faced with significant U.S. government import restrictions in the form of tariffs and quotas. The extent of import protection afforded to domestic apparel producers has been, and is likely to remain, subject to political considerations, and is therefore unpredictable. Given the number of foreign low cost producers, the substantial elimination or scaling back of the import protections that protect domestic apparel producers such as American Apparel could have a material adverse effect on our business and the financial condition and results of operation.

*Because we utilize foreign suppliers and sells into foreign markets, we are subject to numerous risks associated with international business that could increase our costs or disrupt the supply of our products, resulting in a negative impact on our business and financial condition.*

Our international operations subject us to risks, including:

economic and political instability;

restrictive actions by foreign governments;

greater difficulty enforcing intellectual property rights and weaker laws protecting intellectual property rights,

changes in import duties or import or export restrictions;

fluctuations in currency exchange rates, which could negatively affect profit margins;

timely shipping of product and unloading of product through West Coast ports, as well as timely truck delivery to American Apparel's warehouses;

complications complying with the laws and policies of the United States affecting the exportation of goods, including duties, quotas, and taxes; and

complications in complying with trade and foreign tax laws.

These and other factors beyond our control could disrupt the supply of our products, influence the ability of our suppliers to export our products cost-effectively or at all, inhibit our suppliers' ability to procure certain materials and increase our expenses, any of which could harm our business, financial condition and results of operations.

*Litigation exposure could exceed expectations and have a material adverse effect on our financial condition and results of operations.*

American Apparel is subject to regulatory inquiries, investigations, claims and suits. American Apparel is currently defending one sexual harassment suit and responding to several allegations of discrimination and/or harassment that have been filed with the Equal Employment Opportunity Commission or state counterpart agencies. In the event one or more of these matters are decided against us, we could not only incur substantial liability but also experience an increase in similar suits and suffer reputational harm. Furthermore, the previous insurer for the Company's directors' and officers' insurance policy alleges that the sexual harassment suit and two of the allegations of discrimination and/or harassment are not covered by that insurance policy. We are unable to predict the potential financial exposure that could result from these matters. Our estimates of the viability of these claims or the financial exposure in which they could result could change from time to time as the

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matters proceed through their course, as facts are established and various judicial determinations are made. We could have material financial exposure, which would have a material adverse effect upon our financial condition and results of operations. See the section entitled *Business of American Apparel Legal Proceedings* for a more detailed discussion of American Apparel's pending litigation.

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### ***Our ability to request indemnification from AAI's stockholders for damages arising out of the Acquisition has expired.***

At the closing of the Acquisition, 8,064,516 shares of Endeavor common stock issued to Dov Charney were deposited in escrow as the sole remedy for the obligation of the Old American Apparel stockholders to indemnify and hold harmless the Company for any damages, whether as a result of any third party claim or otherwise, and which arise as a result of or in connection with the breach of representations and warranties and agreements and covenants of Old American Apparel. The Company's right to bring a claim for indemnification expired on December 12, 2008 and those shares are no longer subject to the escrow.

### ***The process of upgrading our information technology infrastructure may disrupt our operations.***

We are increasingly dependent on information systems to operate our website, process transactions, respond to customer inquiries, manage inventory and production, purchase, sell and ship goods on a timely basis and maintain cost-efficient operations. American Apparel has performed an evaluation of its information technology systems and requirements and is implementing upgrades to its information technology systems supporting the business. These upgrades involve replacing legacy systems with successor systems, making changes to legacy systems or acquiring new systems with new functionality. There are inherent risks associated with replacing and changing these systems, including accurately capturing data and system disruptions. We may experience operational problems with our information systems as a result of system failures, viruses, computer hackers or other causes. Any material disruption or slowdown of our systems, including a disruption or slowdown caused by our failure to successfully upgrade our systems, could cause information, including data related to customer orders, to be lost or delayed which could especially if the disruption or slowdown occurred during the holiday season result in delays in the delivery of merchandise to our stores and customers or lost sales, which could reduce demand for our merchandise and cause our sales to decline.

Moreover, we may not be successful in developing or acquiring technology that is competitive and responsive to the needs of our customers and might lack sufficient resources to make the necessary investments in technology to compete with our competitors. Accordingly, if changes in technology cause our information systems to become obsolete, or if our information systems are inadequate to handle our growth, we could lose customers.

### ***We have potentially adverse exposure to credit risks on our wholesale sales.***

American Apparel is exposed to the risk of financial non-performance by its customers, primarily in its wholesale business. Sales to wholesale customers represented approximately 30.0% of total sales for the year ended December 31, 2008. American Apparel's extension of credit involves considerable use of judgment and is based on an evaluation of each customer's financial condition and payment history. American Apparel monitors its credit risk exposure by periodically obtaining credit reports and updated financials on its customers. American Apparel maintains an allowance for doubtful accounts for potential credit losses based upon historical trends and other available information. However, delays in collecting or the inability to collect on sales to significant customers or a group of customers could have a material adverse effect on our results of operations.

### ***A failure in our Internet operations, which are subject to factors beyond our control, could significantly disrupt our business and lead to reduced sales and reputational damage.***

Our online retail operations accounted for approximately 7.2% of sales for the year ended December 31, 2008 and are subject to numerous risks that could have a material adverse effect on our operational results. Risks to online revenue include, but are not limited to, the following:

changes in consumer preferences and buying trends relating to Internet usage;

changes in required technology interfaces;

web site downtime;

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difficulty in recreating the in-store experience on a web site; and

risks related to the failure of the systems that operate the web sites and their related support systems, including computer viruses, theft of customer information, telecommunication failures and electronic break-ins and similar disruptions.

Our failure to successfully respond to these risks and uncertainties could reduce Internet sales and damage our brand's reputation.

***Our auditors and management have identified certain material weaknesses in our internal control over financial reporting as of December 31, 2008.***

American Apparel's auditors and management have identified three material weaknesses in American Apparel's internal control over financial reporting as of December 31, 2008, as further described in Item 9A of this Annual Report on Form 10-K. These material weaknesses relate to: (1) a lack of a sufficient number of adequately trained accounting personnel with appropriate expertise in United States Generally Accepted Accounting Principles and lack of sufficient expertise to ensure that certain complex material and non-routine transactions are properly reflected in American Apparel's consolidated financial statements; (2) in certain instances, the Company's personnel, at both U.S. and foreign operations, did not perform adequate independent review of reconciliations and other processes; and (3) the Company's world-wide financial information systems were not integrated and contained many manual processes that may prevent the Company from meeting regulatory filing requirements on a timely and accurate basis. The Company has also identified information technology control weaknesses in the areas of information security, end-user computing, systems program development and change controls. American Apparel's auditors and management also identified five material weaknesses in American Apparel's internal control over financial reporting as of December 31, 2007, which have not been fully remediated as of December 31, 2008. (See Item 9A for further details.) We cannot assure you that we will not have additional material weaknesses in the future or that we will be able to remediate existing material weaknesses.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. In addition, due to the identified material weaknesses, management has concluded that as of December 31, 2008, our disclosure controls and procedures were ineffective. The existence of material weaknesses could adversely affect our ability to report our financial condition and results of operations accurately and on a timely basis and, as a result, we may be unable to timely meet our reporting obligations with the SEC. The existence of material weaknesses also could adversely affect the market price of our common stock and subject us to sanctions or investigations by the NYSE Alternext US, the SEC and other regulatory authorities.

***American Apparel is currently being audited by government tax agencies regarding its operating activities in previous periods which may result in an assessment of a material amount, the payment of which may adversely impact American Apparel's financial conditions and operations.***

As of December 31, 2008, American Apparel is being audited by Government agencies in various jurisdictions in regards to sales, VAT, income, and other taxes for certain previous years. At this time, no assessments have been issued and American Apparel cannot quantify what impact these audits may have, if any. Therefore, no provisions have been set up in the accounts of American Apparel.

***The Company is still in the process of making significant compensation decisions.***

Significant compensation decisions are made by American Apparel's Board of Directors and compensation committee. Currently, only Dov Charney, Joyce Crucillo, our Chief Litigation Counsel, and Glenn Weinman, our General Counsel, have employment agreements with the Company. The compensation arrangements for other key officers and employees are subject to review and change from time to time, including in the near term, by the Board of Directors of American Apparel and its compensation committee.

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*There will be a substantial number of shares of American Apparel's common stock available for sale in the future that may increase the volume of common stock available for sale in the open market and may cause a decline in the market price of American Apparel's common stock.*

The consideration issued in the Acquisition to the American Apparel stockholders included 37,258,065 shares of American Apparel common stock that was issued at the closing to Dov Charney. The resale of these shares has not been registered and these shares are restricted securities under the securities laws. In addition, all of these shares are subject to lock-up agreements and cannot be sold publicly, in the absence of the Company's consent, until the expiration of the restricted period under the lock-up agreement in December 2013 (which period may be shortened to December 2010 upon the occurrence of certain events). The presence of these additional shares of common stock eligible for trading in the public market may have an adverse effect on the market price of American Apparel's common stock.

In addition, American Apparel has outstanding warrants exercisable to purchase an aggregate of 17 million shares of its common stock, representing on an as-converted basis approximately 18% of the outstanding common stock (after giving effect to the issuance of the shares underlying such warrants). SOF Investments, L.P. Private IV (SOF) holds a warrant, expiring on December 19, 2013, to purchase one million shares of American Apparel common stock at an exercise price of \$3.00 per share, which exercise price is subject to adjustment under certain circumstances. In addition, Lion Capital (Guernsey) II Limited (Lion) holds a warrant, expiring on March 13, 2016, to purchase 16 million shares of American Apparel common stock at an exercise price of \$2.00 per share, which exercise price is subject to adjustment under certain circumstances.

*The Company's stock price may be volatile.*

The Company's stock price may fluctuate substantially as a result of quarter to quarter variations in the actual or anticipated financial results of the Company or other companies in the retail industry or markets served by the Company. In addition, the stock market has experienced price and volume fluctuations that have affected the market price of many retail and other stocks and that have often been unrelated or disproportionate to the operating performance of these companies. Failure to meet the expectations of investors, security analysts or credit rating agencies in one or more future periods could reduce the market price of our common stock and cause our credit ratings to decline.

*If we are unable to maintain listing of American Apparel's securities on the NYSE Alternext US (formerly the American Stock Exchange) or any stock exchange, it may be more difficult for American Apparel's stockholders to sell their securities.*

American Apparel's common stock is currently traded on the NYSE Alternext US. If for any reason the NYSE Alternext US should delist American Apparel's securities from trading on its exchange, and American Apparel is unable to obtain listing on Nasdaq or another national securities exchange, American Apparel could face significant material adverse consequences, including:

a limited availability of market quotations for its securities;

a limited amount of news and analyst coverage for American Apparel;

a decreased ability to issue additional securities or obtain additional financing in the future; and

a determination that its common stock is a penny stock, if the securities sell for a substantial period of time at a low price per share which would require brokers trading in its common stock to adhere to more stringent rules, possibly resulting in a reduced level of trading activity in the secondary trading market for American Apparel's common stock.

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*Voting control by our executive officers, directors, lenders and other affiliates may limit your ability to influence the outcome of director elections and other matters requiring stockholder approval.*

Dov Charney and certain pre-Acquisition stockholders are parties to a voting agreement, dated December 12, 2007 (the Endeavor Voting Agreement), entered into upon the closing of the Acquisition. The Endeavor Voting Agreement provides that after the Acquisition, the Board of Directors would have nine members, comprised of four persons designated by Mr. Charney (initially being Mr. Charney, Adrian Kowalewski, Robert Greene and Allan Mayer), four persons designated by the pre-Acquisition stockholders (initially being Mark D. Klein, Mark Samson, Mortimer Singer and Mark A. Thornton), and one person mutually designated by the parties (initially being Keith Miller). Pursuant to the Endeavor Voting Agreement, the parties thereto agreed to vote their shares of Company common stock in favor of such designees to serve as directors. The Endeavor Voting Agreement terminates following the election of directors at the annual meeting of stockholders of the Company to be held in 2010.

In connection with the closing of the financing transaction with Lion, Mr. Charney and Lion entered into a voting agreement, dated March 13, 2009 (the Investment Voting Agreement), and the Company and Lion entered into an investment agreement, dated March 13, 2009 (the Investment Agreement). Pursuant to the Investment Agreement, Lion has the right to designate up to two persons to the Company's Board of Directors and a board observer (or, if the Company increases its board size to 12, Lion has the right to designate up to three persons to the Board of Directors and no board observers), subject to maintaining certain minimum ownership thresholds of, or shares issuable under, the warrant (the Lion Warrant) issued on March 13, 2009, to Lion to purchase 16 million shares of Company common stock at an exercise price of \$2.00 per share, which exercise price is subject to adjustment under certain circumstances. Lion Warrant or shares issuable under the Lion Warrant. Though no change to the existing Board of Directors composition is required under the Investment Agreement, the Company may consider changes in lieu of increasing the size of the Board of Directors. The Company currently expects to determine whether to increase its board size, or make changes to its current board structure to permit the appointment of the Lion designees, within 30 days after the closing date of the transaction. The Investment Agreement also provides that for so long as Lion has the right to designate any person for nomination for election to the Board of Directors pursuant to the Investment Agreement, the Company will not increase the size of the Board of Directors to more than 10 directors (or 13 directors in the event the Company elects to increase the size of the Board of Directors to 12 directors as described above).

Pursuant to the Investment Voting Agreement, for so long as Lion has the right to designate any person or persons to the Board of Directors, Mr. Charney has agreed to vote his shares of common stock in favor of Lion's designees, provided that Mr. Charney's obligation to so vote terminates if he owns less than 6,000,000 shares of Company common stock (which number will be adjusted appropriately to take into account any stock split, reverse stock split or similar transaction). In addition, pursuant to the Investment Voting Agreement, for so long as Lion has the right to designate any person or persons to the Board of Directors, Lion has agreed to vote its shares of common stock in favor of Mr. Charney and, during the term of the Endeavor Voting Agreement, each other designee of Mr. Charney, provided that Lion's obligation to so vote terminates if either (i) Mr. Charney beneficially owns less than 27,900,000 shares of Company common stock (which number will be adjusted appropriately to take into account any stock split, reverse stock split or similar transaction) or (ii) (A) Mr. Charney is no longer employed on a full-time basis by the Company or any subsidiary of the Company and (B) Mr. Charney is in material breach of the non-competition and non-solicitation covenants contained in the Acquisition Agreement, as extended by a letter agreement, dated March 13, 2009, between Mr. Charney and Lion.

Accordingly, the parties to the Endeavor Voting Agreement, the Investment Agreement and the Investment Voting Agreement are able to control the election of directors. Mr. Charney and the other parties to the Endeavor Voting Agreement beneficially own in the aggregate approximately 52.8% of the Company's outstanding common stock and voting power (such calculation does not give effect to dilution as a result of any exercise of

the Lion Warrant or the warrant (the SOF Warrant), issued on December 19, 2008, to SOF to purchase one

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million shares of Company common stock at an exercise price of \$3.00 per share, which exercise price is subject to adjustment under certain circumstances). This concentration of ownership and the Endeavor Voting Agreement and the Investment Voting Agreement could have the effect of delaying or preventing a change in the Company's control or discouraging a potential acquirer from attempting to obtain control of us, which in turn could have a material adverse effect on the market price of the Company's common stock or prevent the Company's stockholders from realizing a premium over the current market price for their shares of Company common stock. Furthermore, Mr. Charney, the other parties to the Endeavor Voting Agreement and Lion may also have interests that differ from yours and may vote their shares of Company common stock in a way with which you disagree and which may be adverse to your interests.

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

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

**Item 1B. Unresolved Staff Comments**

None.

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**Item 2. Properties**

The following table sets forth the location and use of each of American Apparel's principal non-retail properties, which are all leased:

|                          |  |
|--------------------------|--|
| Los Angeles, California  | Executive Offices, Sewing, Cutting, and Distribution (the HQ lease ) |
| Los Angeles, California  | Knitting Facility  |
| Los Angeles, California  | Warehouse  |
| Hawthorne, California    | Fabric Dyeing and Finishing Facility                                 |
| South Gate, California   | Sewing, Garment Dyeing and Finishing Facility                        |
| Garden Grove, California | Knitting, Fabric Dyeing and Finishing Facility                       |
| Commerce, California     | Warehouse Facility   |
| Montreal, Quebec         | Executive Offices, Distribution                                      |
| Düsseldorf, Germany      | Offices, Distribution  |
| Neuss, Germany           | Distribution   |
| London, England          | Offices  |
| Tokyo, Japan             | Offices  |
| Seoul, South Korea       | Offices  |

The HQ lease expired on December 31, 2008. The Company is currently leasing the property on a month-to-month and is currently negotiating with the lessor.

All of American Apparel's retail stores are well maintained and in good operating condition. American Apparel's retail stores are typically leased for a term of five to ten years with renewal options for an additional five to ten years. Most of these leases provide for base rent, as well as maintenance and common area charges, real estate taxes and certain other expenses. Selling space of opened stores will sometimes change due to store renovations that modify space utilization, use of staircases, the configuration of cash registers, and other factors. As well, a number of American Apparel store locations have undergone expansions in the past several years.



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The following tables set forth American Apparel's existing retail stores by geographic region, as of December 31, 2008:

**Domestic Locations (148)**

|                        |                                 |                          |                           |                        |
|------------------------|---------------------------------|--------------------------|---------------------------|------------------------|
| <i>Arizona (3)</i>     | <i>Colorado (2)</i>             | <i>Massachusetts (3)</i> | <i>New York (cont d.)</i> | <i>Texas (cont d.)</i> |
| Scottsdale             | Boulder                         | Boston                   | Noho                      | Dallas                 |
| Tempe                  | Denver                          | Back Bay                 | Soho                      | Mockingbird Station    |
| Tuscon                 |                                 | Newbury                  | Tribeca                   | NorthPark Center       |
|                        | <i>Connecticut (1)</i>          | Cambridge                | Upper East Side           | Houston                |
| <i>California (40)</i> | South Norwalk                   |                          | Upper West Side           | Round Rock             |
| Arcadia                |                                 | <i>Michigan (3)</i>      | West Village              | San Antonio            |
| Berkeley (2)           | <i>District of Columbia (2)</i> | Ann Arbor                | White Plains              | La Cantera             |
| Burlingame             | Georgetown                      | East Lansing             | Woodbury Common           | North Star Mall        |
| Camarillo              | Lincoln Square                  | Royal Oak                |                           |                        |
| Claremont              |                                 |                          | <i>North Carolina (2)</i> | <i>Utah (1)</i>        |
| Commerce               | <i>Florida (11)</i>             | <i>Minnesota (2)</i>     | Charlotte                 | Salt Lake City         |
| Costa Mesa             | Boca Raton                      | Bloomington              | South End                 |                        |
| Gilroy                 | Coconut Grove                   | Minneapolis              | Southpark Mall            | <i>Vermont (1)</i>     |
| Los Angeles            | Coral Gables                    |                          |                           | Burlington             |
| Cherokee               | Fort Lauderdale                 | <i>Missouri (1)</i>      | <i>Ohio (3)</i>           |                        |
| Factory Store          | Gainesville                     | Kansas City              | Cincinnati                | <i>Virginia (1)</i>    |
| Echo Park (2)          | Key West                        |                          | Cleveland                 | Richmond               |
| Hollywood              | Miami Beach                     | <i>Nebraska (1)</i>      | Columbus                  |                        |
| Little Tokyo           | Lincoln Road                    | Omaha                    |                           | <i>Washington (4)</i>  |
| Los Feliz              | Ocean Drive                     |                          | <i>Oregon (4)</i>         | Lynnwood               |
| Melrose                | Sunset Drive                    | <i>Nevada (3)</i>        | Eugene                    | Seattle                |
| Robertson              | Orlando                         | Las Vegas                | Portland                  | Capitol Hill           |

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|                                  |                      |                       |                           |                      |
|----------------------------------|----------------------|-----------------------|---------------------------|----------------------|
| Westwood Village                 | South Miami          | Boca Park             | Hawthorne Blvd.           | Downtown Seattle     |
| West Hollywood                   | St. Augustine        | Caesars Palace        | Stark Street              | University Way       |
| Huntington Beach                 |                      | Premium Outlet        | Bridgeport Village        |                      |
| La Jolla                         | <b>Georgia (3)</b>   |                       |                           | <b>Wisconsin (2)</b> |
| Manhattan Beach                  | Atlanta              | <b>New Jersey (3)</b> | <b>Pennsylvania (5)</b>   | Madison              |
| Napa                             | Buckhead             | Edison                | King of Prussia           | Milwaukee            |
| Palo Alto                        | Little Five Points   | Hoboken               | Philadelphia              |                      |
| Pasadena                         | Savannah             | Paramus               | Sansom Commons            |                      |
| Rancho Cucamonga                 |                      |                       | Walnut Street             |                      |
| San Diego                        | <b>Hawaii (1)</b>    | <b>New York (23)</b>  | Pittsburgh                |                      |
| Fashion Valley                   | Honolulu             | Brooklyn              | Shadyside                 |                      |
| Gaslamp                          |                      | Carroll Gardens       | Univ. of Pittsburgh       |                      |
| Hillcrest                        | <b>Illinois (5)</b>  | Court Street          |                           |                      |
| Pacific Beach                    | Chicago              | Park Slope            | <b>Rhode Island (1)</b>   |                      |
| San Francisco                    | Gold Coast           | Williamsburg          | Providence                |                      |
| Haight Ashbury                   | Lakeview             | Garden City           |                           |                      |
| Union Street                     | Lincoln Park         | Manhattan             | <b>South Carolina (2)</b> |                      |
| Santa Ana                        | Wicker Park          | Chelsea               | Charleston                |                      |
| Santa Barbara                    | Evanston             | Columbia University   | Columbia                  |                      |
| Santa Cruz                       |                      | Columbus Circle       |                           |                      |
| Santa Monica                     | <b>Louisiana (1)</b> | FIT                   | <b>Tennessee (2)</b>      |                      |
| Main Street                      | New Orleans          | Flatiron              | Memphis                   |                      |
| 3 <sup>rd</sup> Street Promenade |                      | Gramercy Park         | Nashville                 |                      |
| Studio City                      | <b>Maryland (4)</b>  | Harlem                |                           |                      |
| Ventura                          | Annapolis            | Hell s Kitchen        | <b>Texas (8)</b>          |                      |
|                                  | Baltimore            | Lower Broadway        | Austin                    |                      |
|                                  | Bethesda             | Lower East Side       | Congress Ave              |                      |
|                                  | Silver Spring        |                       | Guadalupe Street          |                      |



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**Canada (37)**

| <i>Alberta (5)</i>      | <i>British Columbia (7)</i> | <i>Ontario (10)</i> | <i>Quebec (12)</i>      |
|-------------------------|-----------------------------|---------------------|-------------------------|
| Calgary                 | Burnaby                     | Kingston            | Laval                   |
| 17 <sup>th</sup> Avenue | Kelowna                     | London              | Montreal                |
| Market Mall             | Vancouver                   | Ottawa              | Cote-des-Neiges         |
| Sunnyside               | Granville                   | Rideau Centre       | Cours Mont-Royal        |
| Edmonton                | Park Royal                  | Westboro            | Mont-Royal Est          |
| 82 <sup>nd</sup> Avenue | Robson Street               | Toronto             | Sherbrooke              |
| West Edmonton Mall      | South Granville             | Bloor Street        | St-Denis                |
|                         | West 4th Street             | College Street      | St-Laurent              |
|                         |                             | Queen Street        | Ste-Catherine           |
|                         | <i>Manitoba (1)</i>         | Sherway Gardens     | Ste-Catherine Est       |
|                         | Winnipeg                    | Yonge & Dundas      | Pointe-Claire           |
|                         |                             | Yonge & Eglinton    | Quebec                  |
|                         | <i>Nova Scotia (1)</i>      |                     | Sainte-Foy              |
|                         | Halifax                     |                     |                         |
|                         |                             |                     | <i>Saskatchewan (1)</i> |
|                         |                             |                     | Saskatoon               |

**International Locations (75)**

| <u><i>Europe (46)</i></u> | <i>Netherlands (3)</i> | <i>Sweden (1)</i>      |
|---------------------------|------------------------|------------------------|
| <i>Austria (1)</i>        | Amsterdam 1            | Stockholm              |
| Vienna                    | Amsterdam 2            |                        |
|                           | Rotterdam              | <i>Switzerland (2)</i> |
| <i>Belgium (1)</i>        |                        | Zurich 1               |
| Antwerp                   | <i>Germany (13)</i>    | Zurich 2               |

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|                    |                    |                            |
|--------------------|--------------------|----------------------------|
|                    | Berlin 1           |                            |
| <b>France (8)</b>  | Berlin 2           | <b>United Kingdom (13)</b> |
| Aix en Provence    | Berlin             | Brighton                   |
| Paris              | Cologne            | Bristol                    |
| Marais             | Düsseldorf         | Glasgow                    |
| Vielle du Temple   | Frankfurt          | Liverpool                  |
| Beaurepaire        | Hamburg 1          | London                     |
| Marche St-Honore   | Hamburg 2          | Camden                     |
| Avenue Victor Hugo | Heidelberg         | Carnaby Street             |
| Saint-Germain      | Mannheim           | Covent Garden              |
| Toulouse           | Munich 1&2         | Kensington                 |
|                    | Munich 3           | Oxford Street              |
| <b>Italy (3)</b>   | Stuttgart          | Portobello Road            |
| Florence           |                    | Shoreditch                 |
| Milan              | <b>Spain (1)</b>   | Manchester                 |
| Rome               | Barcelona          | Nottingham                 |
| <b>Israel (2)</b>  | <b>Asia (19)</b>   | <b>South Korea (8)</b>     |
| Jerusalem          | <b>China (4)</b>   | Bundang                    |
| Tel Aviv           | Beijing            | Busan                      |
|                    | Nali Mall          | Cheong-Ju                  |
| <b>Mexico (4)</b>  | World Trade Center | Seoul                      |
| Mexico City        | Shanghai           | Chungdam                   |
| La Roma            | Shenzhen           | Dae-Hak-Ro                 |
| Polanco            |                    | Hong-Dae                   |
| Monterrey          | <b>Japan (7)</b>   | Kangnam                    |
| Playa del Carmen   | Fukuoka            | Myung-Dong                 |
|                    | Osaka              |                            |
| <b>Brazil (1)</b>  | Tokyo              |                            |

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São Paulo

Azabu

Daikanyama

*Australia (3)*

Jiyugaoka

Adelaide

Shibuya

Melbourne

Yokohama

Sydney

**Table of Contents****Stores Opened by Year**

|                                     | United States | Canada | International | Total |
|-------------------------------------|---------------|--------|---------------|-------|
| <b>2004</b>                         |               |        |               |       |
| Open at January 1, 2004             | 3             | 0      | 0             | 3     |
| Opened                              | 23            | 9      | 3             | 35    |
| Total as of December 31, 2004       | 26            | 9      | 3             | 38    |
| <b>2005</b>                         |               |        |               |       |
| Opened                              | 40            | 11     | 14            | 65    |
| Total as of December 31, 2005       | 66            | 20     | 17            | 103   |
| <b>2006</b>                         |               |        |               |       |
| Opened                              | 29            | 6      | 11            | 46    |
| Closed                              | (2)           | 0      | 0             | (2)   |
| Total as of December 31, 2006       | 93            | 26     | 28            | 147   |
| <b>2007</b>                         |               |        |               |       |
| Opened                              | 13            | 5      | 20            | 38    |
| Closed                              | (1)           | (1)    | (1)           | (3)   |
| Total as of December 31, 2007       | 105           | 30     | 47            | 182   |
| <b>2008</b>                         |               |        |               |       |
| Opened                              | 44            | 8      | 29            | 81    |
| Closed                              | (1)           | (1)    | (1)           | (3)   |
| Total as of December 31, 2008       | 148           | 37     | 75            | 260   |
| <b>2009 (through February 28th)</b> |               |        |               |       |
| Opened                              | 3             | 1      | 1             | 5     |
| Closed                              | (1)           | (1)    | 0             | (2)   |
| Total                               | 150           | 37     | 76            | 263   |

**Store Pipeline**

As part of American Apparel's new store expansion, at any one time American Apparel may have store locations under signed leases which are in the process of being opened. This store pipeline, as of February 28, 2009 is as follows:

|               |                |                  |                  |
|---------------|----------------|------------------|------------------|
| New Haven, CT | Chicago, IL    | Dresden, Germany | Tijuana, Mexico  |
| Las Vegas, NV | Schaumburg, IL | Dublin, Ireland  | Osaka, Japan     |
|               |                |                  | Montreal, Canada |

**Item 3. Legal Proceedings**

The Company is subject to various claims and contingencies in the ordinary course of its business, including those related to litigation, business transactions, employee-related matters and taxes, and others. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the Company will record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. While there can be no assurances, the Company does not expect that any of its pending legal proceedings will have any material financial impact on the Company's results.



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On or about September 19, 2005, Ms. Mary Nelson, an independent contractor in the sales department at American Apparel, commenced a suit in a case captioned as *Mary Nelson v. American Apparel, Inc., et al.*, Case Number BC333028, filed in Superior Court of the State of California for the County of Los Angeles, Central District, wherein she alleges she was wrongfully terminated, was subjected to harassment and discrimination based upon her gender and other claims related to her tenure at American Apparel. The Company denies all of Ms. Nelson's allegations of wrongdoing. Ms. Nelson is seeking unspecified monetary damages and costs. The trial has been stayed, and the Court of Appeal of the State of California has reversed the Superior Court's denial of the Company's motion to compel arbitration pursuant to an agreement among the parties. The Company anticipates that an arbitration will now occur. As described further below, the insurance carrier for the Company's directors' and officers' insurance policy has asserted that it is not obligated to provide coverage for this proceeding. American Apparel intends to aggressively defend any allegations of wrongdoing.

On February 7, 2006, Sylvia Hsu, a former employee of American Apparel, filed a Charge of Discrimination with the Los Angeles District Office of the Equal Employment Opportunity Commission (EEOC) (*Hsu v. American Apparel: Charge No. 480- 2006-00418*), alleging that she was subjected to sexual harassment by a co-worker and constructively discharged as a result of the sexual harassment and hostile working environment. The EEOC's investigation of this charge is ongoing. On March 9, 2007, the EEOC expanded the scope of its investigation to other employees of American Apparel who may have been sexually harassed. In February 2008, the EEOC requested to speak with certain managers, supervisors and other employees of the Company in connection with its investigation. Given the broad scope of the EEOC's investigation, it is impossible to predict with any degree of accuracy how this matter will develop, how it will be resolved, what remedies or relief, if any, will be sought or what the impact might be on American Apparel. American Apparel intends to aggressively defend any allegations of wrongdoing.

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

The Company is currently engaged in several other employment-related claims and other matters incidental to the Company's business. We believe that all such claims against the Company are without merit, and we intend to vigorously dispute the validity of the plaintiffs' claims. While the ultimate resolution of such claims cannot be determined, based on information at this time, we believe the amount, and ultimate liability, if any, with respect to these actions will not materially affect our business, financial position, results of operations, or cash flows. We cannot assure you, however, that such actions will not have a material adverse effect on our consolidated results of operations, financial position or cash flow.

**Table of Contents****Item 4. Submission of Matters to a Vote of Security Holders**

The Company's Annual Meeting of Stockholders was held on November 20, 2008. The following proposals were presented to a vote of the stockholders.

*Proposal No. 1 Election of Directors (Class A)*

| <b>Director</b> | <b>Votes For</b> | <b>Votes Withheld</b> |
|-----------------|------------------|-----------------------|
| Robert Greene   | 57,052,304       | 7,164,125             |
| Allan Mayer     | 57,053,329       | 7,163,100             |
| Keith Miller    | 57,053,404       | 7,163,025             |

The following Class B directors currently remain in office with their term expiring in 2009 - Adrian Kowalewski, Mark D. Klein and Mortimer Singer. The following Class C directors currently remain in office with their term expiring in 2010 - Dov Charney, Mark Samson and Mark A. Thornton.

Pursuant to the Investment Agreement, Lion has the right to designate up to two persons to the Company's Board of Directors and a board observer (or, if the Company increases its board size to 12, Lion has the right to designate up to three persons to the Board and no board observers). Though no change to the existing Board composition is required under the Investment Agreement, the Company may consider changes in lieu of increasing the size of the Board. The Company currently expects to determine whether to increase its Board size, or make changes to its current Board structure to permit the appointment of the Lion designees, within 30 days after the closing date of the Lion financing transaction. The Investment Agreement also provides that for so long as Lion has the right to designate any person for nomination for election to the Board pursuant to the Investment Agreement, the Company will not increase the size of the Board to more than 10 directors (or 13 directors in the event the Company elects to increase the size of the Board to 12 directors as described above).

*Proposal No. 2 Election of Independent Auditors*

To ratify the appointment of Marcum & Kliegman LLP as the Company's independent auditors for the fiscal year ending December 31, 2008.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
|------------------|----------------------|----------------|
| 64,012,990       | 193,006              | 10,432         |

*Proposal No. 3 Amendment of 2007 Performance Equity Plan*

To approve the amendment to the Company's 2007 Performance Equity Plan (i) to increase the number of shares of Common Stock reserved for issuance thereunder by 3,290,000 shares and (ii) to increase the maximum number of shares of Common Stock that may be granted as awards thereunder to any one individual in any one calendar year from 200,000 to 2,500,000.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
|------------------|----------------------|----------------|
| 49,950,408       | 8,815,179            | 11,862         |

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The principal market on which our common stock is traded is the NYSE Alternext US. Our common stock is traded under the symbol APP. Our units (the Endeavor Units) and warrants (the Endeavor Warrants), which were issued in the initial public offering of Endeavor Acquisition Corp., traded on the American Stock Exchange (now the NYSE Alternext US) under the symbols APP-U and APP-WS, respectively, until March 7, 2008, when all outstanding Endeavor Warrants were redeemed.

Each Endeavor Unit was comprised of one share of common stock and one Endeavor Warrant. Prior to the Acquisition, the Endeavor Units, common stock and Endeavor Warrants were traded on the American Stock Exchange (now the NYSE Alternext US) under the symbols EDA-U, EDA and EDA-WT, respectively. The Endeavor Units commenced trading on the NYSE Alternext US on December 16, 2005, and the common stock and Endeavor Warrants commenced trading on March 6, 2006.

The following table sets forth the range of high and low sales prices for the Endeavor Units, our common stock and the Endeavor Warrants for the periods indicated. The trading activity for the periods prior to December 12, 2007 was for Endeavor Acquisition Corp., a blank check company, prior to the Acquisition. The trading activity for December 13, 2007 through December 31, 2007 and thereafter was for American Apparel.

|                                      | Units    |          | Common Stock |          | Warrants |         |
|--------------------------------------|----------|----------|--------------|----------|----------|---------|
|                                      | High     | Low      | High         | Low      | High     | Low     |
| <b>2007:</b>                         |          |          |              |          |          |         |
| Fourth Quarter (12/13/07 - 12/31/07) | \$ 23.99 | \$ 21.86 | \$ 16.22     | \$ 13.40 | \$ 9.00  | \$ 7.50 |
| Fourth Quarter (10/1/07 - 12/12/07)  | 24.25    | 16.93    | 16.80        | 11.56    | 9.40     | 5.25    |
| Third Quarter                        | 17.75    | 13.59    | 12.15        | 7.55     | 5.87     | 2.90    |
| Second Quarter                       | 19.45    | 14.00    | 13.15        | 9.92     | 6.75     | 3.85    |
| First Quarter                        | 17.50    | 11.70    | 12.20        | 9.12     | 5.75     | 2.99    |
| <b>2008:</b>                         |          |          |              |          |          |         |
| Fourth Quarter                       | \$       | \$       | \$ 8.45      | \$ 1.55  | \$       | \$      |
| Third Quarter                        |          |          | 10.05        | 5.48     |          |         |
| Second Quarter                       |          |          | 9.97         | 5.90     |          |         |
| First Quarter (3/1/08 - 3/7/08)      | 17.78    | 17.78    | 14.45        | 8.50     | 6.00     | 5.90    |

**Dividends**

As a public company, we have not paid any cash dividends. Certain cash dividends and distributions were paid by Old American Apparel to its principal stockholders prior to becoming a public company. We intend to continue to retain earnings for use in the operation and expansion of our business and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

In addition, American Apparel is a holding company and, as a result, its ability to pay dividends is dependent on its subsidiaries' ability to provide funds to it. Restrictions imposed by our debt instruments significantly restrict all of our subsidiaries from making dividends or distributions to American Apparel.

**Units, Common Shares and Warrants**

The Endeavor Warrants and common stock comprising the Endeavor Units became separately tradable on March 7, 2006. Each Endeavor Warrant entitled the holder to purchase from American Apparel one share of American Apparel common stock at an exercise price of \$6.00. On February 6, 2008 the Company called for redemption, and on March 7, 2008 redeemed, all of its issued and outstanding Endeavor Warrants. Prior to the redemption date of March 7, 2008, 16,153 of the 16,165 Endeavor Warrants outstanding at December 31, 2007 were exercised. The remaining 12 Endeavor Warrants were redeemed by the Company at a price of \$.01 per Warrant. As a result, the Endeavor Units and the Endeavor Warrants ceased to be outstanding and ceased to be registered, pursuant to Section 12(b) on March 7, 2008.



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On December 19, 2008, in connection with an extension of the SOF Credit Agreement, the Company issued the SOF Warrants. On March 13, 2009, in connection with the Lion financing, the Company issued the Lion Warrant. The warrants were issued to SOF and Lion in private placements exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended.

The SOF Credit Agreement provided that if the Company failed to raise \$16 million of financing by March 13, 2009, the Company would be required to issue to SOF an additional warrant to purchase two million shares of Company common stock at an exercise price of \$2.00 per share and on other terms substantially identical to the terms of the SOF warrant issued to SOF in December 2008 in connection with the extension of the SOF Credit Agreement. As a result of the repayment in full of the SOF Credit Agreement with the proceeds of the loans under the Lion Credit Agreement, the Company was not required to issue to SOF the additional warrant.

For further discussion, including of proceeds received from exercise of warrants see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources .

## **Equity Compensation Plan Information**

On December 12, 2007, the stockholders approved the 2007 Performance Equity Plan (the 2007 Plan ), which originally provided for an aggregate of 7,710,000 shares of the Company's common stock to be acquired by the holders of awards under the plan. At the Company's Annual Meeting of Stockholders held on November 20, 2008, the Company's stockholders approved an amendment to the 2007 Plan to (i) increase the number of shares of the Company's common stock reserved for issuance under the 2007 Plan by 3,290,000 shares, which increased the maximum number of shares reserved for issuance from 7,710,000 to 11,000,000 and (ii) increase the number of shares of the Company's common stock that may be granted as awards to any one participant in any one calendar year from 200,000 to 2,500,000. The purpose of the 2007 Plan is to enable the Company to offer its employees, officers, directors and consultants whose past, present and/or potential contributions to the Company has been, are or will be important to the success of the Company, an opportunity to acquire a proprietary interest in the Company. The 2007 Plan provides for various types of incentive awards including, but not limited to: incentive stock options, non-qualifying stock options, reload stock options, restricted stock and stock appreciation rights. The 2007 Plan enables the compensation committee to exercise its discretion to determine virtually all terms of each grant, which allows the Company to respond to changes in compensation practices, tax laws, accounting regulations and the size and diversity of its business.

Pursuant to the 2007 Plan, the Company's seven non-employee directors each received a stock grant (of fully vested shares) following the closing of the Acquisition and will receive a stock grant for each year of service thereafter, equal to the number of shares of the Company's common stock having an aggregate market value of \$75,000 at the date of grant. The initial stock grant was approved by the Board on February 6, 2008, subject to the filing and effectiveness of a registration statement on Form S-8, which was filed on April 17, 2008. Pursuant to the Board authorization for the initial stock grant, however, the number of shares awarded to the non-employee directors was to be determined using the highest closing price as of December 12, 2007, February 6, 2008 and April 17, 2008. Consequently, the Company issued to each non-employee director 4,808 shares of common stock, based upon the December 12, 2007 closing price per share of \$15.60. The compensation expense associated with the share awards is approximately \$432,000 and is reflected in operating expenses for the year ended December 31, 2008 in the consolidated financial statements, and was based upon the February 6, 2008 closing price of \$12.85 per share. On January 12, 2009, the Company issued the second annual grant to each non-employee director of approximately 35,000 shares of common stock, based upon the closing price per share of \$2.13.

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On August 14, 2008, 1,850,532 shares of the Company's common stock (fully vested and not subject to any restrictions or conditions) having an aggregate value of \$12.1 million were awarded to eligible manufacturing employees and included in cost of sales for the year ended December 31, 2008. Of the \$12.1 million, approximately \$5.2 million was withheld for the payment of employment and withholding taxes and 1,058,367 shares with an aggregate value of \$6.9 million were issued to employees and cash in the amount of approximately \$7,000 was paid to employees in lieu of the issuance of fractional shares. The net share settlement is deemed to be a repurchase by the Company of its common stock. The value of the stock award was determined based upon the August 14, 2008 closing price per share of \$6.54.

It is anticipated that any options granted under the plan in the future will have an exercise price at least equal to the fair market of American Apparel's common stock on the date of grant. The following table provides information as of December 31, 2008 for common shares of the Company that may be issued under our 2007 Performance Equity Plan.

| Plan category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted-average exercise price of outstanding options, warrants and rights<br>(b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))<br>(c) |
|--|--|--|--|
| Equity compensation plans approved by security holders |  |  | 9,103,297  |
| Total  |  |  | 9,103,297  |

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**Stock Price Performance Graph**

The graph below compares the cumulative total return of our common stock from March 6, 2006 through December 31, 2008 with the cumulative total return of companies comprising the Dow Jones Industrial Average, the S&P Retail Index, and the S&P500. The graph plots the growth in value of an initial investment of \$100 in each of our common stock, the Dow Jones Industrial Average, the S&P Retail Index, the S&P500 over the indicated time periods, and assuming reinvestment of all dividends, if any, paid on the securities. We have not paid any cash dividends and, therefore, the cumulative total return calculation for us is based solely upon stock price appreciation and not upon reinvestment of cash dividends. The stock price performance shown on the graph is not necessarily indicative of future price performance.

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**Item 6. Selected Financial Data**

The following selected financial data are derived from the Consolidated Financial Statements of American Apparel, Inc. and its subsidiaries as of, and for each of the five years ended, December 31, 2008.

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

The data set forth below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Company's Consolidated Financial Statements and notes included elsewhere in this Annual Report on Form 10-K.

|   | 2008                                 | Year Ended December 31, |            |            | 2004        |
|---|--------------------------------------|-------------------------|------------|------------|-------------|
|   |                                      | 2007                    | 2006       | 2005       | (unaudited) |
|   | (In Thousands Except Per Share Data) |                         |            |            |             |
| <b>Selected Statement of Operations Data:</b>   |                                      |                         |            |            |             |
| Net sales   | \$ 545,050                           | \$ 387,044              | \$ 284,966 | \$ 201,450 | \$ 133,824  |
| Gross profit  | \$ 299,115                           | \$ 215,473              | \$ 145,636 | \$ 101,688 | \$ 56,334   |
| Income from Operations  | \$ 36,064                            | \$ 31,122               | \$ 10,572  | \$ 10,782  | \$ 9,477    |
| Net Income (Loss)   | \$ 14,112                            | \$ 15,478               | \$ (1,606) | \$ 3,487   | \$ 6,223    |
| Pro forma Net Income conversion to C Corporation for tax purposes (unaudited)                         | n/a                                  | \$ 9,457                | \$ 257     | \$ 3,121   | \$ 5,727    |
| Cash Distributions/Dividends Paid (1)   | \$                                   | \$ 22,147               | \$ 696     | \$ 1,793   | \$ 1,906    |
| <b>Per Share Data (2)</b>   |                                      |                         |            |            |             |
| Net Earnings (Loss) per share basic   | .20                                  | .32                     | (.03)      | .07        | .13         |
| Net Earnings (Loss) per share diluted   | .20                                  | .31                     | (.03)      | .07        | .13         |
| Pro forma Net Earnings per share conversion to C Corporation for tax purposes (unaudited) basic (3)   | n/a                                  | .19                     | .01        | .06        | .12         |
| Pro forma Net Earnings per share conversion to C Corporation for tax (unaudited) purposes diluted (3) | n/a                                  | .19                     | .01        | .06        | .12         |
| Weighted average number of shares basic   | 69,490                               | 48,890                  | 48,390     | 48,390     | 48,390      |
| Weighted average number of shares diluted   | 70,317                               | 49,414                  | 48,390     | 48,390     | 48,390      |
| Dividends Paid (1)  | \$ .00                               | \$ .45                  | \$ .01     | \$ .04     | \$ .04      |
| <b>Balance Sheet Data (4)</b>   |                                      |                         |            |            |             |
| Total Assets  | \$ 333,005                           | \$ 233,350              | \$ 163,056 | \$ 124,226 | \$ 90,367   |
| Working Capital   | \$ 112,674                           | \$ 2,120                | \$ 38,559  | \$ 40,880  | \$ 20,164   |
| Total Long Term Debt Less Current Maturities  | \$ 105,266                           | \$ 10,744               | \$ 75,546  | \$ 65,365  | \$ 2,703    |
| Stockholders' Equity  | \$ 136,412                           | \$ 61,821               | \$ 12,973  | \$ 14,918  | \$ 13,339   |

(1) Dividends paid represent cash dividends paid by Old American Apparel to its stockholders prior to becoming a public company. The Company does not anticipate paying any cash dividends in the foreseeable future.

(2) See Note 3 (Earnings per share) for an explanation of how earnings per share is calculated.

(3) See Note 3 (Income Taxes) for an explanation of the pro forma presentation.

(4) See Note 2 (Completed Merger) for an explanation of the impact of the reverse merger with Endeavor Acquisition Corp.





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### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

You should read the following discussion together with Part II, Item 6 Selected Financial Data and our audited consolidated financial statements and the related notes thereto included in Item 8 Financial Statements and Supplementary Data. In addition to historical consolidated financial information, this discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Actual results could differ from these expectations as a result of factors including those described under Item 1A, Risk Factors, Special Note Regarding Forward-Looking Statements and elsewhere in this Annual Report on Form 10-K.

#### **Background**

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

The Acquisition was accounted for as a reverse merger and recapitalization of Old American Apparel. Accordingly, for accounting and financial reporting purposes, Endeavor Acquisition Corp. was treated as the acquired company, and Old American Apparel was treated as the acquiring company. The historical financial information and the historical description of our business, for periods and dates prior to December 12, 2007, is that of Old American Apparel and its affiliated companies. (See Note 2 to the Consolidated Financial Statements for further details.)

#### **Overview**

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

#### **Nature of Operations**

American Apparel is a vertically-integrated manufacturer, distributor, and retailer of branded fashion basic apparel. As of December 31, 2008, American Apparel operated 260 retail stores in 19 countries. American Apparel also operates a leading wholesale business that supplies t-shirts and other casual wear to distributors and screen printers.

American Apparel conducts its primary manufacturing operations out of an 800,000 square foot facility in the warehouse district of downtown Los Angeles, California. The facility houses its executive offices, as well as the Company's cutting, sewing, warehousing, and distribution operations. In addition, the Company operates knitting facilities in Los Angeles and Garden Grove, California, where it makes about one third of the fabric the Company uses in manufacturing. The Company also does most of its dyeing and finishing in-house. Company owned dye houses dye approximately 80% of the raw fabric the Company uses in its manufacturing operations. To supplement the Company's in-house production capacity in December 2007, the Company acquired a new sewing, dyeing, and finishing facility in South Gate, California, which began operations in 2008. This facility has capacity for sewing, dyeing and finishing garments. In May 2008, the Company acquired the facility in Garden Grove, California, which has knitting, dyeing and sewing capacity and began operations in June 2008.

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

The business reporting segments of the Company are U.S. Wholesale, U.S. Retail, Canada, and International. The Company believes this method of segment reporting reflects both the way its business segments are managed and the way each segment's performance is evaluated. The U.S. Wholesale segment includes the Company's wholesale operations in the U.S. and its online consumer operations in the U.S. The U.S. Retail segment includes the Company's retail operations in the U.S. The Canada business segment includes retail, wholesale, and online operations in Canada. The International segment includes retail, wholesale, and online operations outside of the U.S. and Canada. The results of the respective business segments exclude corporate expenses, which consist of the shared overhead costs of the Company. These costs are presented separately and generally include, among other things, the following corporate costs: information technology, human resources, accounting and finance, executive compensation and legal. In the fourth quarter of 2008, the Company implemented and recorded a full year impact from changes to its intercompany transfer pricing policy which will significantly reduce the overall effective tax rate on our international earnings. While the application of our updated intercompany transfer pricing policy did not change our revenue or operating performance on a consolidated basis, it impacted the allocation of operating profit amongst our U.S. Wholesale, Canada and International segments in 2008 when compared to prior years. Financial information about each segment, together with certain geographical information, for the fiscal years ended December 31, 2008, 2007 and 2006 are included under Note 18 to the Consolidated Financial Statements contained herein.

As of December 31, 2008, the U.S. Retail segment consisted of 148 retail stores in the United States and the U.S. Wholesale segment consisted of wholesale operations and online operations. As of December 31, 2008, the Canada segment consisted of 37 stores along with wholesale operations while the International segment consisted of 75 retail stores in 17 countries, online storefronts, and 12 overseas wholesale operations. The International segment consisted of the Company's business in the United Kingdom, Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland, Israel, Australia, Brazil, Mexico, Japan, South Korea and China.

In 2008, 29.8% of American Apparel's net revenue was generated from U.S. Wholesale operations, 31.0% from U.S. Retail operations, 12.3% from Canada operations and 26.9% from International operations. In 2007, 37.3% of American Apparel's net revenue was generated from U.S. Wholesale operations, 29.9% from U.S. Retail operations, 11.0% from Canada operations and 21.8% from International operations. In 2006, 44.8% of American Apparel's net revenue was generated from U.S. Wholesale operations, 28.2% from U.S. Retail operations, 10.7% from Canada operations and 16.3% from International operations. Total net revenues for 2008, 2007 and 2006 were \$545 million, \$387 million and \$285 million, respectively, and total net earnings (loss) for 2008, 2007, and 2006 were \$14.1 million, \$15.5 million, and (\$1.6) million respectively.

During the period from January 1, 2006 through December 31, 2008, American Apparel increased its U.S.-based retail stores from 66 to 148, increased its Canada based stores from 20 to 37 and increased its International stores from 17 to 75 in 17 countries. The following tables detail the growth in retail store activity during the years ended December 31, 2008, 2007 and 2006.

| <b>Retail Stores U.S. Retail Segment</b> | <b>Year Ended<br/>December 31,<br/>2008</b> | <b>Year Ended<br/>December 31,<br/>2007</b> | <b>Year Ended<br/>December 31,<br/>2006</b> |
|--|---|---|---|
| Open at beginning of the period          | 105   | 93  | 66  |
| Opened during the period                 | 44  | 13  | 29  |
| Closed during the period                 | (1)   | (1)   | (2)   |
| Open at end of the period                | 148   | 105   | 93  |

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|                                       | Year Ended<br>December 31,<br>2008 | Year Ended<br>December 31,<br>2007 | Year Ended<br>December 31,<br>2006 |
|---------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| <b>Retail Stores - Canada Segment</b> |                                    |                                    |                                    |
| Open at beginning of the period       | 30                                 | 26                                 | 20                                 |
| Opened during the period              | 8                                  | 5                                  | 6                                  |
| Closed during the period              | (1)                                | (1)                                | 0                                  |
| Open at end of the period             | 37                                 | 30                                 | 26                                 |

|   | Year Ended<br>December 31,<br>2008 | Year Ended<br>December 31,<br>2007 | Year Ended<br>December 31,<br>2006 |
|---|------------------------------------|------------------------------------|------------------------------------|
| <b>Retail Stores - International Retail</b> |                                    |                                    |                                    |
| <b>Segment (excluding Canada)</b>           |                                    |                                    |                                    |
| Open at beginning of the period             | 47                                 | 28                                 | 17                                 |
| Opened during the period                    | 29                                 | 20                                 | 11                                 |
| Closed during the period                    | (1)                                | (1)                                | 0                                  |
| Open at end of the period                   | 75                                 | 47                                 | 28                                 |

**Comparable Same Store Sales**

Comparable same store sales are defined as the change in sales for stores that have been open for more than one year over the comparable period of the previous year. The table below shows the comparable same store sales of American Apparel, by quarter for the years ended December 31, 2008, 2007 and 2006, including the number of stores included in the comparison at the end of each period and the increase from the prior comparable period.

|                  | For the Quarter Ended |         |              |             |              |
|------------------|-----------------------|---------|--------------|-------------|--------------|
|                  | March 31              | June 30 | September 30 | December 31 | Year to date |
| 2006             | 16%                   | 0%      | 3%           | 5%          | 5%           |
| Number of Stores | 43                    | 50      | 64           | 83          | 29%          |
| 2007             | 17%                   | 24%     | 27%          | 40%         | 29%          |
| Number of Stores | 104                   | 119     | 131          | 138         |              |
| 2008             | 36%                   | 23%     | 24%          | 11%         | 22%          |
| Number of Stores | 140                   | 145     | 149          | 162         |              |

**Executive Summary**

For the year ended December 31, 2008, the Company reported net sales of \$545.0 million, an increase of \$158.0 million, or 40.8%, over the \$387.0 million reported for the year ended December 31, 2007. The increase in net sales was primarily the result of expansion in the U.S. Wholesale and U.S. Retail distribution channels, the Canada retail distribution channel and the International retail distribution channel, as the Company added new store locations and expanded its product offering in existing stores. The Company selects new store locations based upon consideration of a number of factors, including projected sales potential, financial requirements of the prospective lease agreement, co-tenancy, as well as ancillary benefits such as increase in brand recognition. Since the beginning of 2007, the Company has been expanding its fabric offerings which facilitated introduction of new styles across the wholesale and retail distribution channels. As many as thirty new styles were added to the retail distribution channel of which the most notable was the addition of denim products. Comparable store sales increased 22% for the year ended December 31, 2008 as compared to the year ended December 31, 2007.

Gross margin for the Company decreased to 54.9% in the year ended December 31, 2008 compared to 55.7% for the year ended December 31, 2007. The decrease in gross profit was primarily the result of recording \$12.1 million of share based compensation expense related to the stock award of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008 and \$1.1 million of employer related payroll taxes related to the stock award in cost of sales. The \$13.2 million of expenses related to the stock award



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reduced our gross profit percentage by 2.4%. Excluding the impact of the aforementioned expenses related to the stock award, our gross profit percentage increased to 57.3% in the year ended December 31, 2008 from 55.7% for the year ended December 31, 2007. This increase in gross profit percentage was primarily attributable to an increase in the sales mix during 2008 which included a higher amount of retail sales from the expansion of the U.S. Retail, Canada and International segments which generate higher gross margins than the Company's U.S. Wholesale segment. The gross margin was also favorably impacted from a reduction in inventory reserves of \$1.7 million which increased the gross margin by 0.3% during the year ended December 31, 2008. The reduction in the inventory reserve was primarily the result of the opening of seven new closeout stores in key markets and expansion of certain existing closeout stores to increase inventory selection. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores which specialize in selling certain inventory at discounted prices, resulting in higher inventory turnover of potentially slow-moving inventory.

During the year ended December 31, 2008, the Company hired a significant number of new manufacturing employees to support the anticipated increase in demand for the Company's products throughout the remainder of the year and in the future. Related to this activity, the Company incurred additional recruiting and training costs. Based on the Company's prior experience with hiring new employees, it is expected that the productivity of new employees reaches a normalized level within 90-120 days of the date of hire. Typically, gross margins in the U.S. wholesale segment have been negatively impacted during periods where the Company has undergone an increased level of hiring.

As of April 1, 2008, the Company successfully completed the first phase of the implementation of an Enterprise Resources Planning (ERP) system. This first phase included the conversion of the Company's systems for manufacturing and warehouse operations, inventory management and control and wholesale operations. Direct costs incurred in the implementation during the year ended December 31, 2008 were \$2.2 million. In addition, certain indirect costs and inefficiencies related to the changeover of various system components had a minor negative impact upon the results of operations in 2008. Nonetheless, going forward, the improvements in operating information and control systems are expected to be substantial. Since April 1, 2008, the Company has entered the second phase of the implementation, which will include the financial accounting and control systems for the Company's U.S. Wholesale operations. The second phase is scheduled to be completed in the second quarter of 2009.

The Company's net income for the year ended December 31, 2008 decreased to \$14.1 million compared to \$15.5 million for the year ended December 31, 2007. The decrease in net income during the year ended December 31, 2008 was primarily the result of the stock award to the Company's manufacturing employees in August 2008, offset by continued expansion of the Company's operations in the U.S. Retail, Canada and International segments.

Management of the Company believes that its revenue growth has been enhanced by the addition of new stores, increased online sales, and by an increased focus on building brand awareness and product diversity. This increased focus is designed to keep existing retail customers and to attract new retail customers. To build on this trend in retail revenue growth, the Company is looking to grow its U.S. Retail segment, and the retail portion of its International and Canada segments. As of February 28, 2009, the Company had signed leases for an additional 9 store locations expected to open in 2009. Additionally, the Company is currently selecting, negotiating and reviewing additional new store locations in both domestic and foreign markets.

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

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### **Critical Accounting Estimates and Policies**

Complete descriptions of American Apparel's significant accounting policies are outlined in Note 3 of the *Notes to Consolidated Financial Statements* included in this Annual Report on Form 10-K. The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. American Apparel's critical accounting estimates and policies include:

sales returns and other allowances;

allowance for doubtful accounts;

inventory valuation;

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

income taxes;

foreign currency;

share-based compensation; and

accruals for the outcome of current litigation.

In general, estimates are based on historical experience, on information from third party professionals and on various other sources and assumptions that are believed to be reasonable under the facts and circumstances at the time such estimates are made. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results may vary from these estimates and assumptions under different and/or future circumstances. American Apparel's management considers an accounting estimate to be critical if:

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

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

### **Revenue Recognition**

The Company recognizes product sales revenue when title and risk of loss have transferred to the customer, there is persuasive evidence of an arrangement, shipment and passage of title has occurred, the sales price is fixed or determinable and collectability is reasonably assured.

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Revenue from wholesale product sales is recorded at the time the product is shipped to the customer. Revenue from online sales is recorded at the time the products are delivered to the customers. With respect to its retail store operations, the Company recognizes revenue upon the sale of its products to retail customers. The Company's net sales represent gross sales invoiced to customers, less certain related charges for discounts, returns, and other promotional allowances and are recorded net of sales or value added tax. Allowances provided for these items are presented in the consolidated financial statements primarily as reductions to sales and cost of sales (see "Sales Returns and Allowances" discussed below for further information).

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



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### **Sales Returns and Allowances**

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

### **Trade Receivables**

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

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

### **Inventories**

Inventories are stated at the lower of cost or market. Cost is primarily determined on the first-in, first-out ( FIFO ) method. The Company identifies potentially excess and slow-moving inventories by evaluating turn rates, inventory levels and other factors. Excess quantities are identified through evaluation of inventory aging, review of inventory turns and historical sales experiences. At times however, the Company will purposefully engage in inventory build up at a rate that outpaces sales. This is typically done during the first and second quarters in anticipation of the peak selling season which occurs during the summer months of the second and third quarters of the year. At such times, the Company will consider the timing of inventory buildup in order to determine whether the buildup warrants additional reserves for inventory obsolescence. If the inventory buildup precedes the selling season, management maintains the existing reserve for excess and slow-moving inventory until the peak selling season has passed and the accumulated sales data provides a better basis for an update of management's estimate of this provision. The Company has evaluated the current level of inventories considering historical sales and other factors and, based on this evaluation, has recorded adjustments to cost of goods sold to adjust inventories to net realizable value. These adjustments are estimates, which could vary significantly, either favorably or unfavorably, from actual requirements if future economic conditions, customer

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demand or competition differ from expectations. Other significant estimates include the allocation of variable and fixed production overheads. While variable production overheads are allocated to each unit of production on the basis of actual use of production facilities, the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the Company's production facilities and recognizes abnormal idle facility expenses as current period charges. Certain costs, including categories of indirect materials, indirect labor and other indirect manufacturing costs which are included in the overhead pools are estimated. The Company determines its normal capacity based upon the amount of direct labor minutes in a reporting period.

During 2008, the Company opened seven closeout stores in key markets and expanded certain existing closeout stores to increase their available inventory for sale. Popular styles among the Company's slow-moving stock were actively merchandized in these closeout stores which specialize in selling certain inventory at discounted prices, resulting in higher inventory turnover of potentially excess and slow-moving inventory. The impact of this sales increase in our closeout stores was the primary result of a net reduction of \$1.7 million to the Company's reserve for excess and slow-moving inventory at December 31, 2008.

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

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

### **Long-Lived Assets**

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

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

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

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

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The Company evaluates acquired assets and its retail stores for potential impairment indicators at least annually and more frequently upon the occurrence of certain events. Judgment regarding the existence of impairment indicators is based on market conditions and operational performance of the acquired businesses. Future events could cause the Company to conclude that impairment indicators exist, and therefore that goodwill and other intangible assets as well as other long lived assets are impaired. Such evaluations for impairment are significantly impacted by estimates of future revenues, costs and expenses and other factors. A significant change in cash flows in the future could result in an impairment of long lived assets. During the year ended December 31, 2008, the Company recorded an impairment charge in the amount of \$0.6 million related to underperforming retail stores located in each of the U.S. Retail, Canada and International segments.

## **Foreign Currency**

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

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

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

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

## **Income Taxes**

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

## **Contingencies**

The Company is subject to proceedings, lawsuits and other claims related to various matters. The Company assesses the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. Management determines the amount of reserves needed, if any, for each individual issue based

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on its knowledge and experience and discussions with legal counsel. The required reserves may change in the future due to new developments in each matter, the ultimate resolution of each matter or changes in approach, such as a change in settlement strategy, in dealing with these matters. The Company currently does not believe, based upon information available at this time, that these matters will have a material adverse effect on its consolidated financial position, results of operations or cash flows. However, there is no assurance that such matters will not materially and adversely affect the Company's business, financial position, results of operations or cash flows. See Note 16 and 19 to the Company's Consolidated Financial Statements.

### **Share-Based Compensation**

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

Any such equity awards will be granted through the 2007 Performance Equity Plan, which was adopted by the Company's Board and was approved by the stockholders. The 2007 Performance Equity Plan reserves 11.0 million shares of common stock for issuance in accordance with its terms. All employees, directors, officers and consultants will be eligible to participate in the 2007 Performance Equity Plan. The material terms of the 2007 Performance Equity Plan are further described in the section of the definitive proxy statement entitled "2007 Performance Equity Plan Proposal" filed with the SEC on November 28, 2007. On April 17, 2008, approximately 0.03 million shares of common stock having an aggregate value of \$0.4 million were granted to seven non-employee directors in connection with the closing of the Acquisition. The value of the stock award was based upon the December 12, 2007 closing price per share of \$15.60. On August 14, 2008, approximately 1.9 million shares of common stock having an aggregate value of \$12.1 million were awarded to eligible manufacturing employees. Of the \$12.1 million, \$5.2 million was withheld for payment of employment and withholding taxes, approximately 1.1 million shares with an aggregate value of \$6.9 million were issued to employees and cash was paid to employees in lieu of the issuance of fractional shares. The value of the stock award was based upon the August 14, 2008 closing price per share of \$6.54. As of December 31, 2008, the Company has not granted any stock awards under the 2007 Performance Equity Plan, other than the awards as described above. For further information regarding such grants, also see "Equity Compensation Plan Information" under Item 5 above.

**Table of Contents****Year Ended December 31, 2008 compared to Year Ended December 31, 2007****American Apparel, Inc.****Consolidated Statements of Operations****For the Year Ended, 2008 and 2007****(Dollars in Thousands)**

|  | <b>Year Ended<br/>December 31, 2008<br/>(audited)</b> |             | <b>Year Ended<br/>December 31, 2007<br/>(audited)</b> |             |
|--|---|-------------|---|-------------|
| Net sales                                  | \$ 545,050  | 100.0%      | \$ 387,044  | 100.0%      |
| Cost of sales                              | 245,935   | 45.1%       | 171,571   | 44.3%       |
| Gross profit                               | 299,115   | 54.9%       | 215,473   | 55.7%       |
| Operating expenses                         | 263,051   | 48.3%       | 184,351   | 47.6%       |
| <b>INCOME FROM OPERATIONS</b>              | <b>36,064</b>   | <b>6.6%</b> | <b>31,122</b>   | <b>8.0%</b> |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b> |   |             |   |             |
| Interest expense                           | 13,921  | 2.6%        | 17,541  | 4.5%        |
| Foreign currency transaction loss (gain)   | 621   | 0.1%        | (722)   | (0.2)%      |
| Other expense (income)                     | 155   | 0.0%        | (980)   | (0.3)%      |
| <b>INCOME BEFORE INCOME TAXES</b>          | <b>21,367</b>   | <b>3.9%</b> | <b>15,283</b>   | <b>3.9%</b> |
| Income tax provision (benefit)             | 7,255   | 1.3%        | (195)   | (0.1)%      |
| <b>NET INCOME</b>                          | <b>\$ 14,112</b>                                      | <b>2.6%</b> | <b>\$ 15,478</b>                                      | <b>4.0%</b> |

Pro forma Computation Related to Conversion to C Corporation for income tax purposes (unaudited) for the year ended December 31, 2007  
(Dollars in thousands):

|                                      |                 |             |
|--------------------------------------|-----------------|-------------|
| Historical income before taxes       | \$ 15,283       | 3.9%        |
| Pro forma provision for income taxes | 5,826           | 1.5%        |
| <b>Pro forma net income</b>          | <b>\$ 9,457</b> | <b>2.4%</b> |

**Net Sales:** The following table sets forth American Apparel's net sales for the year ended December 31, 2008 as compared to December 31, 2007 and provides key breakdowns within each segment of net sales growth from period to period. Net Sales were as follows:

|                  | <b>Year Ended<br/>December 31, 2008</b> |               | <b>Year Ended<br/>December 31, 2007<br/>(Dollars in Thousands)</b> |               | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
|------------------|---|---------------|--|---------------|----------------------|---------------------|
|                  | <b>Amount</b>                           | <b>%</b>      | <b>Amount</b>  | <b>%</b>      | <b>Amount</b>        | <b>%</b>            |
| <b>NET SALES</b> | <b>\$ 545,050</b>                       | <b>100.0%</b> | <b>\$ 387,044</b>  | <b>100.0%</b> | <b>\$ 158,006</b>    | <b>40.8%</b>        |

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|                |            |        |            |        |            |       |
|----------------|------------|--------|------------|--------|------------|-------|
| U.S. Wholesale | 162,668    | 29.8%  | 144,478    | 37.3%  | 18,190     | 12.6% |
| U.S. Retail    | 168,653    | 31.0%  | 115,615    | 29.9%  | 53,038     | 45.9% |
| Canada         | 67,280     | 12.3%  | 42,407     | 11.0%  | 24,873     | 58.7% |
| International  | 146,449    | 26.9%  | 84,544     | 21.8%  | 61,905     | 73.2% |
|                | \$ 545,050 | 100.0% | \$ 387,044 | 100.0% | \$ 158,006 | 40.8% |

One significant factor contributing to the overall growth in net sales was the expansion of our international operations, as evidenced by the opening of 29 international retail stores with 1 store closing during the year ended December 31, 2008. In our Canada segment, during the year ended December 31, 2008, 8 retail stores were opened and 1 store was closed. Additionally, during the same period 44 retail stores were opened and 1 retail store was closed in our U.S. Retail business segment. Also of primary significance to the expansion of American Apparel's retail business in the U.S. was the Company's increased focus on building brand awareness and targeted advertising campaigns as further described below.

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Net sales increased \$158.0 million, or 40.8%, from \$387.0 million for the year ended December 31, 2007 to \$545.0 million for the year ended December 31, 2008.

**U.S. Wholesale:** Net sales for American Apparel's U.S. Wholesale segment increased \$18.2 million, or 12.6%, from \$144.5 million for the year ended December 31, 2007 to \$162.7 million for the year ended December 31, 2008. This increase was primarily due to an increase in online sales due to strategic advertising and increased brand awareness. Third party wholesale and online sales increased from \$125.8 million and \$18.7 million in 2007 to \$137.2 million and \$25.5 million in 2008, respectively. One of the primary drivers behind the increase in U.S. Wholesale sales was the ability to meet customer demands through increased stock of inventory on hand. During most of 2008, the Company continued its increase in production in order to meet customer demand during the peak sales season.

**U.S. Retail:** Net sales for the U.S. Retail segment increased \$53.0 million, or 45.9%, from \$115.6 million for the year ended December 31, 2007 to \$168.7 million for the year ended December 31, 2008. Growth was fueled by the addition of retail stores in key markets within the U.S. in 2008 which contributed incremental sales of \$30.4 million over the prior year, as well as a 20.7% increase of \$22.6 million in comparable store sales in 2008 compared to 2007. Same-store sales are calculated as the sales increase over the previous year for stores that have been open for more than twelve months. As of December 31, 2008, the number of open stores was 148, while as of December 31, 2007, the number of open stores was 105.

**Canada:** Net sales for the Canada segment increased \$24.9 million, or 58.7%, from \$42.4 million for the year ended December 31, 2007 to \$67.3 million for the year ended December 31, 2008. This was a result of the addition of retail stores in key markets within Canada which contributed incremental sales of \$13.8 million of the prior year, as well as a 37.7% increase of \$11.1 million in same store sales in 2008 compared to 2007. The number of open retail stores increased to 37 retail stores as of December 31, 2008 from 30 retail stores as of December 31, 2007. The increase in comparable store sales was primarily the result of increased brand awareness and higher sales volumes. Canada wholesale and online sales volume was consistent with the prior year.

**International:** Net sales for the International segment increased \$61.9 million, or 73.2%, from \$84.5 million for the year ended December 31, 2007 to \$146.4 million for the year ended December 31, 2008. This increase was primarily due to the net increase of 28 retail stores in the international segment which contributed incremental sales of \$61.9 million over the prior year, from 47 retail stores as of December 31, 2007 to 75 retail stores as of December 31, 2008. Comparable store sales in the International segment increased 18.3% or \$11.7 million for the year ended December 31, 2008 as compared to the year ended December 31, 2007. During 2008, the Company opened 29 new stores in Australia, Belgium, Brazil, China, France, Germany, Israel, Italy, Japan, Korea, Mexico, Netherlands, Spain, Switzerland and the United Kingdom. During the year ended December 31, 2008, approximately \$14.5 million and \$12.2 million of sales were generated by wholesale and online sales, respectively, compared with \$12.6 million and \$6.6 million for wholesale and online sales, respectively, for the year ended December 31, 2007.

**Cost of Sales:** Cost of sales as a percentage of net sales was 45.1% and 44.3% for the years ended December 31, 2008 and 2007, respectively. The increase was primarily due to the recording \$12.1 million of share based compensation expense related to the stock award of approximately 1.9 million shares of common stock to manufacturing employees on August 14, 2008 and \$1.1 million of employer related payroll taxes related to the stock grant in cost of sales for the year ended December 31, 2008. The \$13.2 million of expenses related to the stock award increased our cost of sales as a percentage of net sales by 2.4%. Excluding the impact of the aforementioned expenses related to the stock award, our cost of sales as a percentage of net sales decreased from 44.3% for the year ended December 31, 2007 to 42.7% for the year ended December 31, 2008. This decrease in cost of sales as a percentage of net sales was primarily due to the change in the overall sales mix during the year ended December 31, 2008 which included a higher level of retail sales as a result of the expansion of the retail business in the U.S. Retail, Canada, and International segments which generate higher gross margins than the U.S. Wholesale segment.

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To supplement the Company's in-house production capacity in December 2007, the Company acquired a new garment dyeing and finishing facility in South Gate, California, which began operations in 2008. The new dyeing and finishing facility is capable of dyeing completely sewn garments and the purchase of these assets added garment dyeing capability to the Company's production process. The new facility began production in January 2008 and will further enhance the Company's capability for in-house quality control. This acquisition included the assumption of the lease for the facility as well as the purchase of all of the tangible personal property at the plant. Startup expenses typically associated with manufacturing at new facilities resulted in approximately \$0.9 million of charges in cost of sales, attributable largely to the fact that, at this location, the Company began to manufacture certain denim based new styles which are more costly to manufacture. The \$0.9 million of additional cost of sales charges represents approximately 1.2% of the total increase in cost of sales.

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

**Gross Profit:** Gross profit percentage decreased from 55.7% of net sales for the year ended December 31, 2007 to 54.9% of net sales for the year ended December 31, 2008. Gross margin was negatively impacted by the \$13.2 million of expenses from the stock award to manufacturing employees, including related employer payroll taxes. The \$13.2 million of expenses decreased our gross margin by 2.4%. Excluding the impact of the aforementioned expenses related to the stock award, our gross margin for the year ended December 31, 2008 increased from 55.7% for the year ended December 31, 2007 to 57.3% for the year ended December 31, 2008. This increase in our gross margin was primarily due to an increase in the mix of sales coming from retail sales versus wholesale, along with an increase in online consumer sales. This benefit was partially offset by the hiring of a significant number of new manufacturing employees to support increased production.

**Operating Expenses:** The following table sets forth American Apparel's operating expenses for the year ended December 31, 2008 as compared to December 31, 2007 (dollars in thousands).

|                            | Year Ended<br>December 31,<br>2008 |       | Year Ended<br>December 31,<br>2007 |       | \$               |             |
|----------------------------|------------------------------------|-------|------------------------------------|-------|------------------|-------------|
|                            | Amount                             | %     | Amount                             | %     | Change<br>Amount | %<br>Change |
| OPERATING EXPENSES         | \$ 263,051                         | 100%  | \$ 184,351                         | 100%  | \$ 78,700        | 42.7%       |
| Selling                    | 168,516                            | 64.1% | 115,602                            | 62.7% | 52,914           | 45.8%       |
| Warehouse and Distribution | 15,606                             | 5.9%  | 10,663                             | 5.8%  | 4,943            | 46.4%       |
| General and Administrative | 78,929                             | 30.0% | 58,086                             | 31.5% | 20,843           | 35.9%       |
|                            | 263,051                            | 100%  | 184,351                            | 100%  | 78,700           |             |

**Operating Expenses:** Operating expenses increased from \$184.4 million for the year ended December 31, 2007 to \$263.1 million for the year ended December 31, 2008, an increase of \$78.7 million or 42.7%. Operating expenses include:

**Selling:** Selling expenses together with unallocated corporate selling, advertising and promotion expenses, for the year ended December 31, 2008, were \$168.5 million, which represented 30.9% of net sales, as compared to \$115.6 million for the year ended December 31, 2007, which represented 29.9% of net sales. Increases in selling expenses are due to the increase in worldwide retail store locations as well as the strategic promotional advertising of the Company's products throughout all of its segments.

Advertising costs attributable as selling expenses for the year ended December 31, 2008 were \$18.4 million, representing 3.4% of net sales, compared with \$12.7 million, or 3.3% of net sales, for the year ended December 31, 2007. Advertising costs increased \$5.7 million mainly due to expenses incurred to promote new store openings and to promote the Company's brand and products, primarily online, but also through print media.



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The number of open stores increased from 182 as of December 31, 2007 to 260 as of December 31, 2008, resulting in an increase in rent and occupancy costs of \$19.4 million during the year ended December 31, 2008 compared to the prior year. Payroll costs increased from \$48.4 million for the year ended December 31, 2007 to \$69.3 million for the year ended December 31, 2008, for an increase of \$20.9 million. This increase in payroll costs was a result of increased staffing levels to support the increased number of stores and higher sales volumes at existing stores. The Company also increased compensation to certain valued employees, as the Company believes that it must provide competitive compensation opportunities so that it can attract, motivate and retain qualified employees.

Costs related to preparing for opening new stores include materials, pre-opening labor and training, utilities, travel, rent and IT labor and costs. Pre-opening costs for the U.S. Retail segment were \$5.8 million for the year ended December 31, 2008 compared to \$1.3 million for the year ended December 31, 2007. The Canadian segment had a total of \$0.5 million in pre-opening expenses for the year ended December 31, 2008 compared to no pre-opening expenses for the year ended December 31, 2007. There was a total of \$4.0 million in pre-opening expenses in the International segment for the year ended December 31, 2008 compared to \$3.9 million for the year ended December 31, 2007.

**Warehouse and Distribution:** Warehouse and distribution expenses for the year ended December 31, 2008 were \$15.6 million as compared to \$10.7 million for the year ended December 31, 2007, an increase of \$4.9 million or 46.4%. These expenses represented 2.9% and 2.8%, respectively, of the total net sales for the years ended December 31, 2008 and 2007. The increase in warehouse and distribution expense is attributable to increases of \$4.1 million in staffing expenses necessary to support increased volume and sales growth, primarily in the retail business.

**General and Administrative:** General and administrative expenses for the year ended December 31, 2008 were \$78.9 million, as compared to \$58.1 million for the year ended December 31, 2007, an increase of \$20.8 million or 35.9%. General and administrative expenses represented 14.5% and 15.0% of total net sales for the years ended December 31, 2008 and 2007, respectively.

General and administrative expenses increased by approximately \$7.5 million due to an increase in corporate overhead and \$13.4 million due to growth in the administrative structure required to support the growth in the company's retail business in the U.S. Retail, Canada and International segments. The total number of retail stores increased from 182 opened stores at December 31, 2007 to 260 opened stores at December 31, 2008.

Corporate overhead expenses for the year ended December 31, 2008 increased to \$37.2 million, as compared to \$29.7 million for the year ended December 31, 2007, an increase of \$7.5 million. The increase in corporate overhead expenses was the result of additional expenses for higher salaries and payroll related expenses and professional fees due to increased staffing and the regulatory environment of operating as a public company in 2008. Of the \$7.5 million increase in corporate expenses, professional and consulting fees increased by \$5.8 million and the remaining \$1.7 million increase was primarily due to an increase in information technology and web development expenses. Professional and consulting fees were \$12.3 million and \$6.5 million for the years ended December 31, 2008 and 2007, respectively. The \$5.8 million increase in professional and consulting fees primarily related to an increase of \$2.5 million in accounting fees directly related to public company reporting and compliance requirements, \$1.9 million in legal fees and \$1.4 million in consulting fees related to review work required under the Sarbanes-Oxley Act of 2002 and other initiatives.

**Interest Expense:** The major components of interest expense for the year ended December 31, 2008 consisted of interest on the outstanding revolving credit facility, loans from related and unrelated parties and the term loan facility with SOF. The Company used proceeds from the exercise of the warrants in the first quarter of 2008 to reduce the level of debt outstanding. The reduction in the level of debt resulted in a \$3.6 million decrease in interest expense from \$17.5 million for the year ended December 31, 2007 to \$13.9 million for the year ended December 31, 2008. Interest rates on debt ranged from 6% to 21% during the year ended December 31, 2008,

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compared to 4.6% to 24% for the year ended December 31, 2007. Interest expense represented 2.6% and 4.5% of the total net sales for the years ended December 31, 2008 and 2007, respectively. The net decrease in interest expense was also attributable to the decreased LIBOR rate in the year ended December 31, 2008. Interest expense also included approximately \$0.5 million of loan fees, relating to renegotiating the terms of the Company's Credit Agreement.

**Other Expense/Income:** Other expense was \$0.2 million for the year ended December 31, 2008 as compared to other income of \$1.0 million for the year ended December 31, 2007. The increase in other (income) expense is attributable to tariff charges assessed and prior uncollected receivables. Other expense represented 0.0% of the total net sales for the year ended December 31, 2008 as compared to other income which represented (0.3%) of the total net sales for the year ended December 31, 2007.

**Income Taxes:** Income tax provision increased from \$0.2 million benefit for the year ended December 31, 2007 to \$7.3 million expense for the year ended December 31, 2008.

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

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

**Net Income:** The Company's net income for the year ended December 31, 2008 decreased by approximately \$1.4 million to \$14.1 million compared to \$15.5 million for the year ended December 31, 2007 as a result of the various factors described above.

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**Year Ended December 31, 2007 compared to Year Ended December 31, 2006**

**American Apparel, Inc.**

**Consolidated Statements of Operations**

**For the Year Ended, 2007 and 2006**

**(Dollars in Thousands)**

|  | Year Ended<br>December 31, 2007<br>(audited) |             | Year Ended<br>December 31, 2006<br>(audited) |               |
|--|--|-------------|--|---------------|
| Net sales                                  | \$ 387,044                                   | 100.0%      | \$ 284,966                                   | 100.0%        |
| Cost of sales                              | 171,571                                      | 44.3%       | 139,330                                      | 48.9%         |
| Gross profit                               | 215,473                                      | 55.7%       | 145,636                                      | 51.1%         |
| Operating expenses                         | 184,351                                      | 47.6%       | 135,064                                      | 47.4%         |
| <b>INCOME FROM OPERATIONS</b>              | <b>31,122</b>                                | <b>8.0%</b> | <b>10,572</b>                                | <b>3.7%</b>   |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b> |  |             |  |               |
| Interest expense                           | 17,541                                       | 4.5%        | 11,812                                       | 4.1%          |
| Foreign currency transaction gain          | (722)  | (0.2)%      | (601)  | (0.2)%        |
| Other Income                               | (980)  | (0.3)%      | (607)  | (0.2)%        |
| <b>INCOME (LOSS) BEFORE INCOME TAXES</b>   | <b>15,283</b>                                | <b>3.9%</b> | <b>(32)</b>                                  | <b>0.0%</b>   |
| Income tax (benefit) provision             | (195)  | (0.1)%      | 1,574  | 0.6%          |
| <b>NET INCOME (LOSS)</b>                   | <b>\$ 15,478</b>                             | <b>4.0%</b> | <b>\$ (1,606)</b>                            | <b>(0.6)%</b> |

Pro forma Computation Related to Conversion to C Corporation for income tax purposes (unaudited):

|  | For the years ended December 31,<br>(Dollars in thousands) |             |               |             |
|--|--|-------------|---------------|-------------|
|  | 2007   |             | 2006          |             |
| Historical income (loss) before taxes          | \$ 15,283  | 3.9%        | \$ (32)       | 0.0%        |
| Pro forma provision (benefit) for income taxes | 5,826  | 1.5%        | (289)         | 0.0%        |
| <b>Pro forma income</b>                        | <b>\$ 9,457</b>  | <b>2.4%</b> | <b>\$ 257</b> | <b>0.0%</b> |

**Net Sales:** The following table sets forth American Apparel's net sales for the year ended December 31, 2007 as compared to December 31, 2006 and provides key breakdowns within each segment of net sales growth from period to period. Net Sales were as follows:

|                  | Year Ended<br>December 31, 2007 |               | Year Ended<br>December 31, 2006<br>(Dollars in Thousands) |               | \$<br>Change<br>Amount | %<br>Change  |
|------------------|---------------------------------|---------------|---|---------------|------------------------|--------------|
|                  | Amount                          | %             | Amount  | %             |                        |              |
| <b>NET SALES</b> | <b>\$ 387,044</b>               | <b>100.0%</b> | <b>\$ 284,966</b>   | <b>100.0%</b> | <b>102,078</b>         | <b>35.8%</b> |

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|                |            |        |            |        |            |       |
|----------------|------------|--------|------------|--------|------------|-------|
| U.S. Wholesale | 144,478    | 37.3%  | 127,761    | 44.8%  | 16,717     | 13.1% |
| U.S. Retail    | 115,615    | 29.9%  | 80,210     | 28.2%  | 35,405     | 44.1% |
| Canada         | 42,407     | 11.0%  | 30,570     | 10.7%  | 11,837     | 38.7% |
| International  | 84,544     | 21.8%  | 46,425     | 16.3%  | 38,119     | 82.1% |
|                | \$ 387,044 | 100.0% | \$ 284,966 | 100.0% | \$ 102,078 |       |

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One significant factor contributing to the overall growth in net sales period to period was the expansion of our international operations, as evidenced by the opening of 20 international retail stores with 1 store closing during the year ended December 31, 2007. In our Canada segment, during the year ended December 31, 2007, 5 retail stores were opened and 1 store was closed. Additionally, during the same period 13 retail stores were opened and 1 retail store was closed in our U.S. Retail business segment. Also of primary significance to the expansion of American Apparel's retail business in the U.S. was the Company's increased focus on building brand awareness and targeted advertising campaigns as further described below.

Net Sales increased \$102.1 million, or 35.8% from \$284.9 million for the year ended December 31, 2006 to \$387.0 million for the year ended December 31, 2007.

**U.S. Wholesale:** Net sales for American Apparel's U.S. Wholesale segment increased \$16.7 million, or 13.1%, for the year ended December 31, 2007 as compared to the year ended December 31, 2006, primarily as a result of an increase in online sales due to strategic advertising and increased brand recognition, as well as organic growth of the wholesale business. One of the primary drivers behind the increase in U.S. Wholesale sales was the ability to meet customer demands through increased stock of inventory on hand. During 2007, compared to 2006, the Company went through a phase of increased production in order to meet customer demand during the peak sales season. Online sales increased from \$9.2 million in 2006 to \$18.9 million in 2007, an increase of \$9.7 million.

**U.S. Retail:** Net sales for the U.S. Retail segment increased \$35.4 million, or 44.1%, for the year ended December 31, 2007 as compared to the year ended December 31, 2006, fueled by the addition of retail stores in key markets within the U.S. in 2007, as well as a 26.2% increase in comparable store sales in 2007 compared to 2006. Same-store sales are calculated as the sales increase over the previous year for stores that have been open for more than twelve months. As of December 31, 2007, the number of open stores was 105, while as of December 31, 2006, the number of open stores was 93.

**Canada:** Net sales for the Canada segment increased \$11.8 million, or 38.7%, for the year ended December 31, 2007 as compared to the year ended December 31, 2006, as a result of the addition of retail stores in key markets within Canada, as well as a 26.3% increase in same store sales in 2007 compared to 2006. Canada wholesale sales decreased to \$11,335 in 2007 from \$13,097 in 2006 for a total decrease of \$1,762 or 19.6%. This decrease can be attributed to our increased efforts to expand our wholesale clientele. As of December 31, 2007, the number of open stores was 30, while as of December 31, 2006, the number of open stores was 26.

**International:** Net sales for the International segment increased \$38.1 million, or 82.1%, in the year ended December 31, 2007 as compared to the year ended December 31, 2006. This increase was primarily due to the net increase of 19 international stores opened from 28 in 2006 to 47 in 2007 and partially due to a 35.5% increase in same store sales in 2007 compared to 2006. In the year ended December 31, 2007, American Apparel opened six additional stores in Germany, five in the United Kingdom, two each in Korea and France, and one each in Italy, Japan, Israel, Netherlands and Sweden and closed one store in Korea. During the year ended December 31, 2007, approximately 12.6 million and \$6.6 million of the international sales were generated by wholesale and online sales, respectively, compared with \$6.2 million and \$2.8 million in sales for wholesale and online sales, respectively, for the year ended December 31, 2006.

**Cost of Sales:** Cost of sales decreased as a percentage of net sales from 48.9% in the year ended December 31, 2006 to 44.3% in the year ended December 31, 2007. Decrease in cost of sales as a percentage of net sales was primarily related to increases in retail sales which have a higher margin. Decrease in the cost of sales is also a result of better operational efficiencies realized through production during the year ended December 31, 2007. During that period American Apparel was operating closer to its normal production capacity, with lower overtime costs, and better capacity utilization.

**Gross Profit:** Gross profit increased from \$145.6 million for the year ended December 31, 2006 to \$215.5 million for the year ended December 31, 2007, which represents an increase of 48.0%. The overall increase in

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gross profit is a result of growth in retail sales which realize higher margins. This increase in gross profit is also a result of an increased amount of sales being generated from the International segments and the portion of the U.S. Wholesale segment related to online sales. In the International segment, there was growth in International online sales and the addition of new retail stores contributed to sales which generated higher margins.

**Operating Expenses:** The following table sets forth American Apparel's operating expenses for the year ended December 31, 2007 as compared to December 31, 2006 (dollars in thousands).

|                            | Year Ended<br>December 31,<br>2007 |       | Year Ended<br>December 31,<br>2006 |       | \$<br>Change<br>Amount | %<br>Change |
|----------------------------|------------------------------------|-------|------------------------------------|-------|------------------------|-------------|
|                            | Amount                             | %     | Amount                             | %     |                        |             |
| <b>OPERATING EXPENSES</b>  | \$ 184,351                         | 100%  | \$ 135,064                         | 100%  | \$ 49,287              | 36.5%       |
| Selling                    | 115,602                            | 62.7% | 83,957                             | 62.2% | 31,645                 | 37.7%       |
| Warehouse and Distribution | 10,663                             | 5.8%  | 9,721                              | 7.2%  | 942                    | 9.7%        |
| General and Administrative | 58,086                             | 31.5% | 41,386                             | 30.6% | 16,700                 | 40.4%       |
|                            | \$ 184,351                         | 100%  | \$ 135,064                         | 100%  | \$ 49,287              |             |

**Operating Expenses:** Operating expenses increased from \$135.1 million to \$184.4 million for the year ended December 31, 2007, which represents an increase of 36.5%. Operating expenses include:

**Selling:** Selling expenses together with unallocated corporate selling, advertising and promotion expenses, for the year ended December 31, 2007 were \$115.6 million, which represented 29.8% of net sales, as compared to \$84.0 million the year ended December 31, 2006, which represented 29.5% of net sales.

Increases in selling expenses are primarily due to the increase in worldwide retail stores as well as the strategic promotional advertising of the Company's brands and product styles throughout all of its segments. The net increase in selling expenses is attributable to the following: Advertising costs increased \$5.3 million mainly due to the expenses incurred to promote new store openings and to strategically promote the Company's product styles through print ads, magazines and online media. Payroll costs increased \$16.1 million as a result of increased staffing levels to support new store openings. Opened stores increased from 147 in 2006 to 182 in 2007, driving an increase in rent and occupancy costs of \$7.7 million. Expenses for store maintenance and store supplies increased \$2.5 million, due to Company expansion driven by new store openings and as a result of new lease agreements entered into for new stores.

**Warehouse and Distribution:** Warehouse and distribution expenses for the year ended December 31, 2007 as compared to the year ended December 31, 2006 increased by \$0.9 million. These expenses represented 2.7% and 3.4%, respectively of the total net sales for 2007 and 2006. Increase in international warehouse and distribution expenses is primarily due to an increase in transportation costs (such as import fees, duties and carrier costs of \$0.3 million) to distribute the merchandise to international subsidiaries and an increased number of international locations where merchandise is shipped. The increase in warehouse and distribution expense is also attributable to increases of \$0.4 million in staffing necessary to support increased volume and sales growth, with the remaining \$0.2 million in warehouse & distribution expense increase due to other miscellaneous expense increases.

**General and Administrative:** General and administrative expenses of the segments for the year ended December 31, 2007 were \$58.1 million, as compared to \$41.4 million for the year ended December 31, 2006, an increase of \$16.7 million, or 40.4%. General and Administrative expenses represented 15.0% and 14.5% of total net sales for the years ended December 31, 2007 and 2006, respectively.

The U.S. Wholesale segment's general and administrative expenses increased in 2007 primarily due to higher levels of staffing necessary to support the expansion of American Apparel. The increase in the general and administrative expenses was primarily due to the additional staffing and administrative structure required to support a higher number of retail locations, depreciation and amortization costs increased due to

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buildouts of leasehold improvements and additions of information systems equipment required to support the growth in wholesale, retail and online distribution channels. In total, there was a \$2.6 million increase in staffing expenses, a \$3.1 million increase in depreciation and amortization, an increase of \$3.7 million in professional fees, an increase in management fees of \$3.7 million, a \$0.9 million increase in repair and maintenance costs, and a \$2.5 million increase in bonuses paid. The remainder of the increases is due to changes in miscellaneous expenses.

**Interest Expense:** The major components of interest expense in 2007 were interest on the outstanding revolving credit facility, loans from related and unrelated parties and a term loan from a private investment firm. American Apparel increased its levels of debt in 2007 primarily in order to finance its expansion and buildout of retail stores opened during the period. Financing was also used to purchase additional manufacturing and information systems equipment required to support higher manufacturing to support increased sales in all segments. Interest rates on debt ranged from 4.6% to 24% during the year ended December 31, 2007. Interest expense for the year ended December 31, 2007 was \$17.5 million as compared to \$11.8 million for the year ended December 31, 2006. These expenses represented 4.5% and 4.1%, respectively, of the total net sales for 2007 and 2006. The net increase in interest expense is attributable to the increase in interest bearing debt. There was no significant change in the effective interest rate. Total interest bearing debt increased from \$94.9 million at December 31, 2006 to \$114.1 million at December 31, 2007.

**Other Income:** Other income for the year ended December 31, 2007 as compared to the year ended December 31, 2006 increased by \$0.4 million. Other income represented (0.3)% of the total net sales for 2007 and (0.2%) for 2006. The increase in other income is primarily due to rebates received from environmental fees (as a result of a Company-wide environmentally-friendly waste recycling program), as well as miscellaneous insurance recoveries.

**Income Taxes:** Income tax (benefit) provision decreased from \$1.6 million for the year ended December 31, 2006 to \$(0.2) million for the year ended December 31, 2007.

Prior to July 1, 2004, the Company operated as a C corporation under U.S. tax law. Effective July 1, 2004, the stockholders elected to be taxed under Subchapter S of the Internal Revenue Code (the "S Corporation Election"). During the period of the S Corporation Election, federal income taxes and certain state taxes were the responsibility of the Company's stockholders. The S Corporation Election terminated with the consummation of the Acquisition on December 12, 2007. As a result of the Company's conversion from the S corporation status for U.S. tax purposes to the C corporation status on December 12, 2007, the deferred tax assets and liabilities were adjusted to reflect the change in federal and state tax rates applicable to C corporations. This resulted in a deferred tax benefit of \$6.2 million being recognized and included in the 2007 tax (benefit) provision.

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

**Net Income (Loss):** American Apparel's net income (loss) after income taxes for the year ended December 31, 2006 as compared to the year ended December 31, 2007 were (\$1.6) million and \$15.5 million, respectively. A significant factor contributing to the increase in American Apparel's net income after income taxes from 2006 to 2007 was a significant increase in net sales, combined with the reduction in cost of sales as a percentage of net sales, and recognition of a deferred tax benefit as a result of the conversion from S Corporation to a C Corporation.

On a pro forma basis, for 2007, conversion to a C Corporation resulted in income before taxes of \$15.2 million. Pro forma net income for 2007 was \$9.4 million.

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### **Liquidity and Capital Resources**

Over the past year, the Company's growth has been funded through a combination of borrowings from related and unrelated parties, bank debt and lease financing.

As of December 31, 2008, the Company had (i) approximately \$11.4 million in unrestricted cash, (ii) \$12.1 million available and \$49.4 million outstanding under the revolving credit facility, dated July 2, 2007, with Bank of America, N.A. (successor by merger to LaSalle Business Credit, LLC, as agent for LaSalle Bank Midwest National Association), Wells Fargo Retail Finance, LLC and the lenders party thereto (the BofA Credit Agreement), and (iii) \$51.0 million of borrowings outstanding under its credit agreement, dated January 18, 2007, with SOF (the SOF Credit Agreement). See Debt Agreements below for an overview of the BofA Credit Agreement, the SOF Credit Agreement and the Company's other debt agreements.

On March 13, 2009, American Apparel entered into a Credit Agreement (the Lion Credit Agreement) among the Company, in its capacity as Borrower, certain subsidiaries of the Company, in their capacity as Facility Guarantors, Lion Capital LLP, in its capacity as administrative agent and collateral agent, Lion, as Initial Lender (in such capacity, the Initial Lender), and the other lenders from time to time party thereto (together with the Initial Lender, the Second Lien Lenders). Pursuant to the Lion Credit Agreement, the Initial Lender made term loans to the Company in an aggregate principal amount equal to \$80 million, of which \$5 million constitute a fee paid by the Company to Lion Capital LLP in connection with the Lion Credit Agreement. A portion of the proceeds of the loans made under the Lion Credit Agreement was used by the Company to repay in full all outstanding amounts due and owing under the SOF Credit Agreement. The remaining proceeds were used to reduce the outstanding revolver balance under the BofA Credit Agreement, to repay \$3.25 million of loans owed by the Company to Dov Charney, and to pay fees and expenses related to the transaction. In connection with the loans under the Lion Credit Agreement, the Company issued to Lion a seven-year warrant, which is exercisable at any time during its term, to purchase an aggregate of 16 million shares of the Company's common stock at an exercise price of \$2.00 per share, which exercise price is subject to adjustment under certain circumstances. The Lion Warrant may be exercised by Lion by paying the exercise price in cash, pursuant to cashless exercise of the Lion Warrant or by a combination of the two methods. As a result of financing obtained from Lion the Company believes that it currently has sufficient cash and financing commitments to meet its funding requirements through December 2009.

In connection with the financing from Lion, the Company also entered into an amendment to the BofA Credit Agreement to, among other things: (i) consent to the Lion Credit Agreement, (ii) permit certain repayments of the promissory notes due to Dov Charney, and (iii) fix the maturity date at July 2, 2012.

On December 19, 2008, in connection with an amendment to the BofA Credit Agreement, Dov Charney loaned the Company \$2.5 million in exchange for a promissory note. On February 10, 2009, Dov Charney loaned the Company an additional \$4.0 million in exchange for a promissory note. The promissory notes were to mature in January 2013 and provided for interest at an annual rate of 6%, payable in kind. The promissory notes were repaid in an aggregate amount equal to \$3.25 million with a portion of the proceeds of the loans under the Lion Credit Agreement.

On December 19, 2008, in connection with an amendment to the SOF Credit Agreement, the Company issued the SOF Warrant, which expires on December 19, 2013 and is exercisable at any time during its term. This amendment to the SOF Credit Agreement, among other things, extended the maturity date of the SOF Credit Agreement from January 18, 2009 to April 20, 2009.

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



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On April 17, 2008, the Company issued 33,656 shares of Company common stock having an aggregate value of \$0.4 million were granted to seven non-employee directors in connection with the closing of the Acquisition. The value of the stock award was based upon the December 12, 2007 closing price per share of \$15.60.

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

## **Cash Flow Overview**

### **Year Ended December 31, 2008**

For the year ended December 31, 2008, cash provided by operations was \$21.2 million. This was a result of income from operations before non-cash expenses (primarily depreciation and amortization, stock-based compensation, deferred income taxes, deferred rent expense and bad debt recovery) of \$49.0 million, an increase in accounts payable and accrued expenses of \$23.7 million and an increase in income taxes payable of \$2.1 million, offset by the increase in inventory of \$44.6 million, increase in trade and other receivables of \$1.2 million and an increase in prepaid expenses and other current assets of \$8.1 million. The increase in inventory levels during 2008 included raw material purchases and production of product to support American Apparel's growth in the U.S. Wholesale segment and continued expansion of the retail business in U.S. Retail, Canada and International segments.

For the year ended December 31, 2008, the Company used \$72.1 million of cash in investing activities. This was primarily a result of increased investment in property and equipment for the U.S. wholesale segment by approximately \$14.8 million and an increased investment in property and equipment of \$30.9 million for the U.S. Retail, \$4.7 million in the Canada segment and \$18.3 million in the International segment. In addition, the Company acquired all of the assets of a fabric dyeing and finishing plant for \$3.5 million.

For year ended December 31, 2008, cash provided by financing activities was \$41.2 million. This was primarily the result of the Company's principal capital requirements to fund working capital needs and to finance opening of new retail stores, as well as to finance purchase of new manufacturing and information systems equipment to support higher production levels and growth in online operations. Proceeds from exercise of warrants amounted to \$65.6 million offset by the \$10.0 million repurchase of treasury shares and \$5.2 million to satisfy the applicable income tax withholding obligations in connection with the net share settlement of some of the Endeavor Warrants which is deemed to be a repurchase by the Company of its common stock. Other financing activities included receipt of a \$2.5 million loan from Dov Charney, offset by debt repayments and financing costs.

### **Year Ended December 31, 2007**

For the year ended December 31, 2007, cash used in operations was \$(5.4) million. This was a result of income from operations before non-cash expenses (primarily depreciation and amortization, deferred income taxes, deferred rent expense and bad debt recovery) of \$(24.7) million, and an increase in income taxes payable of \$3.8 million, offset by the increase in inventory of \$22.2 million, decrease in receivables of \$.05 million, increase in prepaid expenses and other current assets of \$2.3 million, and decrease in accounts payable and accrued expenses of \$7.3 million. Cash used in operations was primarily used to reduce obligations to trade and other vendors. Cash used in operations was also used to finance an increase in inventory production levels during the first two quarters of 2007 through raw material purchases to support American Apparel's peak selling season that generally occurs from the months of May through September, as well as a related increase in production selling and administrative staff payroll.

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For the year ended December 31, 2007, American Apparel used \$23.8 million of cash in investing activities. This was partially a result of increased investment in property and equipment for the U.S. wholesale segment by approximately \$5.3 million and an increased investment in property and equipment of \$18.5 million for the U.S. retail and other segments. In 2007, American Apparel invested in new cutting, sewing, information systems equipment required to support the increased production levels experienced during 2007. Increase in investment in property and equipment for the retail segment was due to the 38 new retail stores that were opened in the year ended December 31, 2007.

For year ended December 31, 2007, cash from financing activities was \$44.5 million. This was primarily the result of \$123 million cash acquired in the Acquisition, the buy out of Sang Ho Lim, the other stockholder of Old American Apparel prior to the Acquisition, of \$67.9 million, decreases to the line of credit pursuant to the BofA Credit Agreement of \$2.7 million, increases to the term loans and notes payable pursuant to the SOF Credit Agreement of \$58.2 million offset by payments to term loans notes, payable and capital leases of \$41.9 million, and distributions and advances to stockholders of \$21.6 million. American Apparel's principal capital requirements were to fund working capital needs and to finance opening of new retail stores, as well as to finance purchases of new manufacturing and information systems equipment to support higher production levels and growth in online operations.

**Year Ended December 31, 2006**

For the year ended December 31, 2006, cash provided by operations was \$7.7 million. This is a result of income from operations before non-cash expenses (primarily depreciation and amortization, inventory reserve and deferred rent expense) of \$16.0 million offset by the increase in inventory of \$13.3 million, decrease in other assets of \$4.6 million and the increase in accounts payable and accrued expenses of \$8.8 million. Cash provided by operations was a direct result of buildup in trade payables due to liquidity issues in late 2006 until additional financing was secured. This financing was completed in January 2007.

For the year ended December 31, 2006, cash used in investing activities was \$16.9 million. This is a result of investments in property and equipment for the wholesale, retail and other segments to support the growth of American Apparel. The retail segment opened 46 new stores during the year ended December 31, 2006. During 2006, American Apparel invested in leasehold improvements to support buildouts and opening of new retail stores.

For the year ended December 31, 2006, cash from financing activities was \$10.2 million. This is a result of increases to the Company's line of credit of \$6.8 million, increases in term loans and notes payable of \$7.6 million offset by payments to term loans and notes payable of \$7.4 million, payments to capital lease obligations of \$3.2 million and distributions and advances to stockholders of \$1.1 million.

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

The following is an overview of American Apparel's long term and current debt as of December 31, 2008 (dollar amounts in thousands).

| Description of Debt                           | Lender Name                              | Interest Rate      | December 31, 2008 | Covenant Violations | Reference |
|---|--|--------------------|-------------------|---------------------|-----------|
| Revolving credit line                         | Bank of America                          | LIBOR + 4.5%       | \$ 49,401         | No                  | a         |
| Revolving credit line (Canada)                | Toronto Dominion Bank                    | Prime + 1.00%      | 409               | Yes                 | b         |
| Term loan from private investment firm        | SOF                                      | 16.0%              | 51,000            | No                  | c         |
| Other   |  |                    | 558               |                     |           |
| Total long term debt                          |  |                    | 101,368           |                     |           |
| Less current portion of debt                  |  |                    | (1,380)           |                     |           |
| Long-term debt, net of current portion        |  |                    | 99,988            |                     |           |
| Capital lease obligations                     | 61 individual leases ranging between \$1 | From 6.1% to 17.9% | 4,602             |                     | d         |
| Subordinated notes payable to related parties | \$428                                    | 6%                 | 3,292             |                     | e         |
| Cash overdraft                                |  |                    | 2,413             |                     |           |
| Total debt                                    |  |                    | \$ 111,675        |                     |           |

(a) On July 2, 2007, the Company replaced its secured revolving credit facility of \$62,500 with an increased revolving credit facility (the Credit Agreement) of \$75,000 from a new bank (the Bank). The Credit Agreement was to expire on March 21, 2009, the date thirty days prior to the April 20, 2009 maturity date of the loan agreement with SOF Investments L.P. Private IV (SOF), as discussed below, unless the SOF loan was refinanced on terms acceptable to the Bank. The SOF loan was refinanced on March 13, 2009 (see Note 20 to the accompanying consolidated financial statements). As such, the Credit Agreement will now mature on July 2, 2012. In accordance with SFAS No. 6, Classification of Short-Term Obligations Expected to Be Refinanced, an amendment of ARB No. 43, Chapter 3A, the outstanding loan balance of \$49,401 at December 31, 2008 is reflected as a long-term liability in the accompanying consolidated balance sheet.

Borrowings under the Credit Agreement are subject to certain advance provisions established by the Bank and are collateralized by substantially all of the Company's assets. Interest under the agreement is at LIBOR (2.59% at December 31, 2008) plus 4.5% or the Bank's prime rate (which rate can in no event be lower than LIBOR plus 2.5% per annum) (3.25% at December 31, 2008) plus 2.5%, at the Company's option. The average borrowings under the Company's revolving credit facility during the year ended December 31, 2008 were \$51,438.

The Company has amended the Credit Agreement on five occasions to address various matters, most recently on December 19, 2008. As a precondition to the effectiveness of the fifth amendment, Dov Charney, CEO, was required to make a subordinated loan to the Company in the amount of \$2,500 (see Note 11 to the accompanying consolidated financial statements). Significant covenants included in the Credit Agreement, as amended, include limiting the Company's capital expenditures to \$9,262 in the first quarter of 2009 and to approximately \$8,500 for the remainder of 2009. The Company was in compliance with the financial covenants at December 31, 2008.

(b) At December 31, 2008, the CI Companies had a line of credit with a bank that provided for borrowings up to C\$4,000 due on demand, bearing interest at the bank's prime rate (3.5% at December 31, 2008) plus 1.00% per annum, payable monthly. This line of credit is secured by two \$7,500 moveable hypothecs, which provides for a charge on the CI Companies' accounts receivable, inventory and all other moveable assets and by Section 427 security under the Bank Act of Canada on



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inventory. The credit agreement contains various covenants which require the CI Companies to maintain certain financial ratios and commitments as defined by the bank. At December 31, 2008, the CI Companies were not in compliance with certain of its covenants. Subsequent to year end, the CI Companies signed a new banking agreement with its bank and the U.S. affiliate has subrogated its note in the amount of \$6,527 in favor of the bank. With this, the CI Companies are in compliance with its bank covenants.

(c) As of December 31, 2008, the Company had a term loan agreement with SOF originally dated January 18, 2007 with a balance of \$41,000, which was subsequently increased to \$51,000 on July 22, 2007. Indebtedness under the agreement bore interest at 16% per annum, payable monthly and was to mature on April 20, 2009. The SOF loan was fully repaid on March 13, 2009 from the proceeds of a term loan with a new lender. The SOF term loan agreement required the Company to meet certain financial covenants. In the event the Company was in default under the agreement, the interest rate increased to 21% per annum and SOF had the right to demand payment in full of all outstanding indebtedness. The SOF term loan was collateralized by substantially all assets of the Company subject to prior liens with respect to any such assets under the Credit Agreement with the Bank. In accordance with SFAS No. 6, Classification of Short-Term Obligations Expected to Be Refinanced, an amendment of ARB No. 43, Chapter 3A, the outstanding loan balance of \$51,000 at December 31, 2008 is reflected as a long-term liability in the accompanying consolidated balance sheet.

The covenants included in the SOF term loan agreement were substantially similar to the covenants included in the Credit Agreement with the Bank (see above). The Company amended the SOF term loan agreement nine times, most recently on December 19, 2008. In connection with the ninth amendment, the Company paid SOF a fee of \$2,550 and issued warrants (the SOF Warrants ) to purchase 1,000 shares of Company common stock at an exercise price of \$3.00 per share (see Note 15 of the accompanying consolidated financial statements for a description of the terms and accounting for the SOF Warrants). Under the terms of the ninth amendment, if the Company were to fail to raise \$16 million of financing by March 13, 2009, the Company would be required to issue to SOF warrants to purchase an additional 2,000 shares of Company common stock on the same terms as the SOF Warrants. As discussed above, the SOF loan was repaid on March 13, 2009, and the additional SOF Warrants were not required to be issued.

(d) American Apparel leases certain equipment under capital lease arrangements expiring at various times through 2013. The assets and liabilities under capital leases are recorded at the lower of the present values of the minimum lease payments or the fair values of the assets.

(e) During the year ended December 31, 2008, the Company repaid outstanding loan balances to the Company's Chief Executive Officer ( CEO ). Loans from the CEO were reduced from \$3,804 and \$2,232 at December 31, 2007 to \$0 and \$792 at December 31, 2008, respectively. Both loans bear interest at 6% commencing December 12, 2007 and were scheduled to mature in 2012. On December 19, 2008, the Company received \$2,500 from the CEO in exchange for a promissory note scheduled to mature in January 2013, which bears interest at 6%, payable in kind. Prior to December 12, 2007, related party loans were non-interest bearing and without terms of repayment. For the years ended December 31, 2008, December 31, 2007 and December 31, 2006, interest of \$346, \$277 and \$157, respectively. For the periods prior to December 12, 2007, interest has been imputed at an average rate of 14% and was credited as an addition to paid-in capital.

**Financial Covenants**

American Apparel's credit arrangements impose certain restrictions on American Apparel regarding capital expenditures and limit American Apparel's ability to: incur additional indebtedness, dispose of assets, make repayments of indebtedness or amendments of debt instruments, pay distributions, create liens on assets and enter into sale and leaseback transactions, investments, loans or advances and acquisitions. In addition, the BofA

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Credit Agreement imposes a minimum availability requirement, and the Lion Credit Agreement includes a total debt to consolidated EBITDA ratio financial covenant. Such restrictions could limit American Apparel's ability to respond to market conditions, to provide for unanticipated capital investments or to take advantage of business or acquisition opportunities.

**Contractual Obligations Summary**

The following table summarizes American Apparel's contractual commitments as of December 31, 2008, which relate to future minimum payments due under non-cancelable licenses, leases, long-term debt and advertising commitments. Future minimum rental payment on operating lease obligations presented below do not include any related property insurance, taxes, maintenance or other related costs required by operating leases. Operating lease rent expenses, including the related real estate taxes and maintenance costs, are included in the Cost of sale and General and administrative expenses in American Apparel's financial statements and amounted to approximately \$59,205 for the year ended December 31, 2008.

| Contractual Obligations                       | Total      | Less than<br>1 year | Payments due by period |            |                      |
|---|------------|---------------------|------------------------|------------|----------------------|
|   |            |                     | 1-3 years              | 4-5 years  | More than<br>5 years |
| Long term debt, including interest            | \$ 146,250 | \$                  | \$ 24,288              | \$ 121,962 | \$                   |
| Current debt, including interest              | 12,303     | 12,303              |                        |            |                      |
| Capital lease obligations, including interest | 5,141      | 3,011               | 2,000                  | 130        |                      |
| Operating lease obligations                   | 390,904    | 55,343              | 100,466                | 89,906     | 145,189              |
| Advertising commitments                       | 2,439      | 2,439               |                        |            |                      |
| Total   | \$ 557,037 | \$ 73,096           | \$ 126,754             | \$ 211,998 | \$ 145,189           |

Over the past year, American Apparel's growth has been funded through a combination of borrowings from related and unrelated parties, bank debt and lease financing. As of December 31, 2008, American Apparel had approximately \$11.4 million in unrestricted cash.

**Off-Balance Sheet Arrangements**

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

**Inflation**

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

**Accounting Pronouncements-Newly Issued and Adopted**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157 Fair Value Measurements, ( SFAS No. 157 ) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company

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has implemented SFAS No. 157 and has determined that the results did not have a material impact on its consolidated financial statements.

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

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

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

In February 2008, the FASB issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. This FSP defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008 and the interim periods within those fiscal years for items within the scope of this FSP. The Company has evaluated this new FSP and has determined that it will not have a significant impact on the determination or reporting of our financial results.

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

In April 2008, the FASB issued FASB Staff Position SFAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in

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developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets . The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, Business Combinations, and other U.S. Generally Accepted Accounting Principles ( GAAP ). FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP SFAS 142-3 is effective January 1, 2009, and is not expected to have a material the impact on the Company s consolidated financial statements.

In June 2008, the FASB ratified the consensus reached by the EITF on Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock* ( EITF No. 07-5 ). EITF No. 07-5 provides guidance for determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity s own stock. EITF No. 07-5 applies to any freestanding financial instrument or embedded feature that has all of the characteristics of a derivative or freestanding instrument that is potentially settled in an entity s own stock. To meet the definition of indexed to own stock, an instrument s contingent exercise provisions must not be based on (a) an observable market, other than the market for the issuer s stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer s own operations, and the variables that could affect the settlement amount must be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. EITF No. 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company will adopt EITF No. 07-5 as of January 1, 2009.

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

**Item 7A. Quantitative and Qualitative Disclosures about Market Risks**

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

Based on American Apparel s interest rate exposure on variable rate borrowings at December 31, 2008, a 1% increase in average interest rates on American Apparel s borrowings would increase future interest expense by approximately \$42 per month. American Apparel determined these amounts based on approximately \$49,810 of variable rate borrowings at December 31, 2008, multiplied this amount by 1% and divided by twelve. American Apparel is currently not using any interest rate collars or hedges to manage or reduce interest rate risk. As a result, any increase in interest rates on American Apparel s variable rate borrowings would increase interest expense and reduce net income.

The majority of American Apparel s operating activities are conducted in U.S. dollars. Approximately 39.3% of American Apparel s sales are denominated in other currencies such as Euros, or British Pounds Sterling. Nearly all of American Apparel s production costs and material costs are denominated in U.S. dollars although the majority of the yarn is sourced from outside the United States. If the U.S. dollar were to appreciate by 10% against other currencies it could have a significant adverse impact on American Apparel s earnings. Since an appreciated dollar makes goods produced in the United States relatively more expensive to overseas customers, other things being equal, the Company would have to lower its retail margin in order to maintain sales volume overseas. A lower retail margin overseas would adversely affect net income assuming sales volume remains the same.

For the purpose of the current year s financial statements the respective functional currency shall be the Canadian dollar for our Canadian subsidiaries, the pound Sterling for our U.K. subsidiaries, the Euro for our subsidiaries in Continental Europe, the Yen for our Japanese subsidiary, the Won for our South Korea subsidiary, and local currencies for any of the foreign subsidiaries not mentioned.



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**American Apparel, Inc.**

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**AND FINANCIAL STATEMENT SCHEDULE**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Audit Committee of the

Board of Directors and Stockholders of

American Apparel, Inc.

We have audited the accompanying consolidated balance sheets of American Apparel, Inc. (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss) and cash flows for the years ended December 31, 2008, 2007 and 2006. Our audits also included the financial statement schedule for the years ended December 31, 2008, 2007 and 2006 listed in the index at Item 15. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Apparel, Inc. as of December 31, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years ended December 31, 2008, 2007 and 2006 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), American Apparel's internal control over financial reporting as of December 31, 2008, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated, March 16, 2009, expressed an adverse opinion on the effectiveness of the Company's internal control over financial reporting because of the existence of material weaknesses.

/s/ Marcum & Kliegman LLP

New York, NY

March 16, 2009

**Table of Contents****Item 8. Financial Statements and Supplementary Data****American Apparel, Inc. and Subsidiaries****Consolidated Balance Sheets**

(Amounts in Thousands, except per share amounts)

**December 31, 2008 and 2007**

|   | <b>2008</b>       | <b>2007</b>       |
|---|-------------------|-------------------|
| <b>ASSETS</b>   |                   |                   |
| <b>CURRENT ASSETS</b>   |                   |                   |
| Cash  | \$ 11,368         | \$ 19,292         |
| Trade accounts receivable, net of allowances of \$1,441 and \$1,876 at December 31, 2008 and 2007, respectively   | 16,439            | 16,602            |
| Other receivables   | 1,438             | 1,120             |
| Prepaid expenses and other current assets   | 3,931             | 4,498             |
| Inventories, net  | 148,154           | 106,434           |
| Deferred taxes, current portion   | 5,628             | 4,894             |
| <b>Total Current Assets</b>   | <b>186,958</b>    | <b>152,840</b>    |
| <b>PROPERTY AND EQUIPMENT, net</b>  | <b>112,408</b>    | <b>64,868</b>     |
| <b>INTANGIBLE ASSETS, net</b>   | <b>10,086</b>     | <b>2,286</b>      |
| <b>GOODWILL</b>   | <b>1,906</b>      | <b>950</b>        |
| <b>DEFERRED TAXES</b>   | <b>8,444</b>      | <b>3,146</b>      |
| <b>OTHER ASSETS</b>   | <b>13,203</b>     | <b>9,260</b>      |
| <b>TOTAL ASSETS</b>   | <b>\$ 333,005</b> | <b>\$ 233,350</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                   |                   |
| <b>CURRENT LIABILITIES</b>  |                   |                   |
| Cash overdraft  | \$ 2,413          | \$ 2,778          |
| Current portion of long-term debt   | 1,380             | 99,930            |
| Accounts payable  | 32,731            | 15,451            |
| Accrued expenses  | 26,289            | 21,877            |
| Income taxes payable  | 8,855             | 7,300             |
| Current portion of capital lease obligations  | 2,616             | 3,384             |
| <b>Total Current Liabilities</b>  | <b>74,284</b>     | <b>150,720</b>    |
| <b>LONG-TERM DEBT, Net of current portion</b>   | <b>99,988</b>     | <b>642</b>        |
| <b>SUBORDINATED NOTES PAYABLE TO RELATED PARTIES</b>  | <b>3,292</b>      | <b>6,036</b>      |
| <b>CAPITAL LEASE OBLIGATIONS, net of current portion</b>  | <b>1,986</b>      | <b>4,066</b>      |
| <b>DEFERRED RENT</b>  | <b>17,043</b>     | <b>10,065</b>     |
| <b>TOTAL LIABILITIES</b>  | <b>196,593</b>    | <b>171,529</b>    |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                   |                   |
| <b>STOCKHOLDERS EQUITY</b>  |                   |                   |
| Preferred stock, \$.0001 par value, authorized 1,000 shares; none issued  |                   |                   |
| Common stock, \$.0001 par value, authorized 120,000 shares; 72,221 shares issued and 70,787 shares outstanding at December 31, 2008 and 57,595 shares issued and outstanding at December 31, 2007 | 7                 | 6                 |
| Additional paid-in capital  | 131,252           | 57,162            |
| Accumulated other comprehensive (loss) income   | (2,703)           | 865               |

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|  |                   |                   |
|--|-------------------|-------------------|
| Retained earnings                                | 17,900            | 3,788             |
|  | 146,456           | 61,821            |
| Less: Treasury stock, 1,434 shares at cost       | (10,044)          |                   |
| <b>TOTAL STOCKHOLDERS EQUITY</b>                 | <b>136,412</b>    | <b>61,821</b>     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b> | <b>\$ 333,005</b> | <b>\$ 233,350</b> |

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

**Table of Contents****American Apparel, Inc. and Subsidiaries****Consolidated Statements of Operations**

(Amounts in Thousands, except per share amounts)

**For the Years Ended December 31, 2008, 2007 and 2006**

|   | <b>2008</b> | <b>2007</b> | <b>2006</b> |
|---|-------------|-------------|-------------|
| <b>NET SALES</b>  | \$ 545,050  | \$ 387,044  | \$ 284,966  |
| <b>COST OF SALES</b> (including share-based compensation of \$12,102 for the year ended December 31, 2008)  | 245,935     | 171,571     | 139,330     |
| <b>GROSS PROFIT</b>   | 299,115     | 215,473     | 145,636     |
| <b>OPERATING EXPENSES</b> (including share-based compensation of \$530 for the year ended December 31, 2008 and related party charges of \$619, \$6,111 and \$2,135 for the years ended December 31, 2008, 2007 and 2006, respectively) | 263,051     | 184,351     | 135,064     |
| <b>INCOME FROM OPERATIONS</b>   | 36,064      | 31,122      | 10,572      |
| <b>INTEREST AND OTHER (INCOME) EXPENSE</b>  |             |             |             |
| Interest expense (including related party interest expense of \$346, \$1,633 and \$655 for the years ended December 31, 2008, 2007 and 2006, respectively)  | 13,921      | 17,541      | 11,812      |
| Foreign currency transaction loss (gain)  | 621         | (722)       | (601)       |
| Other expense (income)  | 155         | (980)       | (607)       |
| <b>TOTAL INTEREST AND OTHER EXPENSE</b>   | 14,697      | 15,839      | 10,604      |
| <b>INCOME (LOSS) BEFORE INCOME TAXES</b>  | 21,367      | 15,283      | (32)        |
| <b>INCOME TAX PROVISION (BENEFIT)</b>   | 7,255       | (195)       | 1,574       |
| <b>NET INCOME (LOSS)</b>  | \$ 14,112   | \$ 15,478   | \$ (1,606)  |
| Weighted average basic shares outstanding   | 69,490      | 48,890      | 48,390      |
| Weighted average diluted shares outstanding   | 70,317      | 49,414      | 48,390      |
| Basic Earnings (loss) per share   | \$ 0.20     | \$ 0.32     | \$ (0.03)   |
| Diluted Earnings (loss) per share   | \$ 0.20     | \$ 0.31     | \$ (0.03)   |
| <b>PRO FORMA COMPUTATION RELATED TO CONVERSION TO C CORPORATION FOR INCOME TAX PURPOSES (unaudited):</b>  |             |             |             |
| Historical income (loss) before income taxes  |             | \$ 15,283   | \$ (32)     |
| Pro forma provision (benefit) for income taxes  |             | 5,826       | (289)       |
| <b>Pro forma net income</b>   |             | \$ 9,457    | \$ 257      |
| Pro forma Basic Earnings per share  |             | \$ 0.19     | \$ 0.01     |
| Pro forma Diluted Earnings per share  |             | \$ 0.19     | \$ 0.01     |

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

**Table of Contents****American Apparel, Inc. and Subsidiaries****Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)**

(Amounts in Thousands)

For the Years Ended December 31, 2008, 2007 and 2006

|   | Number of<br>Common<br>Shares | Par<br>Value<br>Amount | Treasury<br>Stock | Additional<br>Paid-in<br>Capital | Due from<br>Stockholders | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Total<br>Stockholders<br>Equity | Comprehensive<br>Income<br>(Loss) |
|---|-------------------------------|------------------------|-------------------|----------------------------------|--------------------------|---|----------------------|---------------------------------|-----------------------------------|
| <b>BALANCE, January 1, 2006</b>   | <b>48,390</b>                 | <b>\$ 5</b>            | <b>\$</b>         | <b>\$ 5,920</b>                  | <b>\$ (158)</b>          | <b>\$ (114)</b>   | <b>\$ 9,265</b>      | <b>\$ 14,918</b>                |                                   |
| Advances to stockholders  |                               |                        |                   |                                  | (395)                    |   |                      | (395)                           |                                   |
| Distributions to stockholders   |                               |                        |                   |                                  |                          |   | (696)                | (696)                           |                                   |
| Imputed interest on stockholder loans   |                               |                        |                   | 277                              |                          |   |                      | 277                             |                                   |
| Net loss  |                               |                        |                   |                                  |                          |   | (1,606)              | (1,606)                         | \$ (1,606)                        |
| Foreign currency translation  |                               |                        |                   |                                  |                          | 475   |                      | 475                             | 475                               |
| <b>BALANCE, December 31, 2006</b>   | <b>48,390</b>                 | <b>5</b>               |                   | <b>6,197</b>                     | <b>(553)</b>             | <b>361</b>  | <b>6,963</b>         | <b>12,973</b>                   | <b>\$ (1,131)</b>                 |
| Outstanding shares of the Registrant at time of reverse merger dated 12/12/07         | 19,933                        | 2                      |                   | 121,587                          |                          |   |                      | 121,589                         |                                   |
| Buy out of Sang Ho Lim  | (11,132)                      | (1)                    |                   | (67,902)                         |                          |   |                      | (67,903)                        |                                   |
| Repayment of stockholders advances  |                               |                        |                   |                                  | 553                      |   |                      | 553                             |                                   |
| Distributions to stockholders   |                               |                        |                   | (15,764)                         |                          |   | (6,383)              | (22,147)                        |                                   |
| Reclass deferred merger costs   |                               |                        |                   | (1,003)                          |                          |   |                      | (1,003)                         |                                   |
| Imputed interest on stockholder loans   |                               |                        |                   | 577                              |                          |   |                      | 577                             |                                   |
| Capitalization of undistributed S Corporation earnings                                |                               |                        |                   | 12,270                           |                          |   | (12,270)             |                                 |                                   |
| Exercise of warrants  | 200                           |                        |                   | 1,200                            |                          |   |                      | 1,200                           |                                   |
| Cashless exercise of underwriters unit purchase options                               | 204                           |                        |                   |                                  |                          |   |                      |                                 |                                   |
| Net income  |                               |                        |                   |                                  |                          |   | 15,478               | 15,478                          | \$ 15,478                         |
| Foreign currency translation  |                               |                        |                   |                                  |                          | 504   |                      | 504                             | 504                               |
| <b>BALANCE, December 31, 2007</b>   | <b>57,595</b>                 | <b>6</b>               |                   | <b>57,162</b>                    |                          | <b>865</b>  | <b>3,788</b>         | <b>61,821</b>                   | <b>\$ 15,982</b>                  |
| Exercise of Warrants  | 13,521                        | 1                      |                   | 65,617                           |                          |   |                      | 65,618                          |                                   |
| Purchase treasury stock   |                               |                        | (10,044)          |                                  |                          |   |                      | (10,044)                        |                                   |
| Issuance of common stock for stock-based compensation, net of payroll tax withholding | 1,105                         |                        |                   | 7,452                            |                          |   |                      | 7,452                           |                                   |
| Issuance of warrants  |                               |                        |                   | 1,021                            |                          |   |                      | 1,021                           |                                   |
| Net income  |                               |                        |                   |                                  |                          |   | 14,112               | 14,112                          | \$ 14,112                         |
| Foreign currency translation, net of tax  |                               |                        |                   |                                  |                          | (3,568)   |                      | (3,568)                         | (3,568)                           |

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|                                   |               |             |                    |                   |           |                   |                  |                   |                  |
|-----------------------------------|---------------|-------------|--------------------|-------------------|-----------|-------------------|------------------|-------------------|------------------|
| <b>BALANCE, December 31, 2008</b> | <b>72,221</b> | <b>\$ 7</b> | <b>\$ (10,044)</b> | <b>\$ 131,252</b> | <b>\$</b> | <b>\$ (2,703)</b> | <b>\$ 17,900</b> | <b>\$ 136,412</b> | <b>\$ 10,544</b> |
|-----------------------------------|---------------|-------------|--------------------|-------------------|-----------|-------------------|------------------|-------------------|------------------|

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

**Table of Contents****American Apparel, Inc. and Subsidiaries****Consolidated Statements of Cash Flows****(Dollars in Thousands)****For the Years ended December 31, 2008, 2007, and 2006**

|   | 2008       | 2007       | 2006       |
|---|------------|------------|------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |            |            |            |
| Cash received from customers  | \$ 544,062 | \$ 386,931 | \$ 284,678 |
| Cash paid to suppliers, employees and others  | (499,184)  | (372,595)  | (266,262)  |
| Income taxes paid   | (11,351)   | (3,247)    | (1,019)    |
| Interest paid   | (12,194)   | (17,533)   | (10,338)   |
| Other   | (162)      | 1,006      | 611        |
| Net cash provided by (used in) operating activities   | 21,171     | (5,438)    | 7,670      |
| <b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>  |            |            |            |
| Capital expenditures  | (68,650)   | (22,195)   | (16,890)   |
| Purchase of net assets under business acquisition   | (3,500)    | (1,600)    |            |
| Net cash used in investing activities   | (72,150)   | (23,795)   | (16,890)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |            |            |            |
| Cash overdraft from financial institution, net  | (288)      | (1,212)    | (590)      |
| Borrowings (repayments) under revolving credit facility, net                                  | 1,381      | (2,659)    | 6,753      |
| Deferred financing costs paid   | (4,139)    | (1,630)    |            |
| Advances to stockholders, net   |            | (21,594)   | (1,091)    |
| Proceeds from exercise of Warrants  | 65,619     | 1,200      |            |
| Purchase of treasury stock  | (10,044)   |            |            |
| Repurchase of common stock for payment of payroll tax withholding on stock-based compensation | (5,174)    |            |            |
| Cash acquired in reverse Merger   |            | 123,000    |            |
| Buy out of Sang Ho Lim  |            | (67,903)   |            |
| Payment of merger-related costs   |            | (1,003)    |            |
| Borrowings of notes payable to related party  | 2,500      | 4,732      | 5,445      |
| Repayment of notes payable to related parties   |            | (6,804)    | (813)      |
| Borrowings under notes payable to unrelated parties   | 966        | 2,118      | 4,406      |
| Repayment under notes payable to unrelated parties  | (1,336)    | (8,288)    | (1,088)    |
| (Repayments of) borrowings under subordinated note payable to related party                   | (4,580)    | (360)      | 180        |
| (Repayment of) borrowing under subordinated note payable to unrelated party                   |            | (14,201)   |            |
| Borrowings under term loans and notes payable   |            | 51,386     | 7,637      |
| Repayment of term loans and notes payable   |            | (8,685)    | (7,385)    |
| Repayment of capital lease obligations  | (3,734)    | (3,567)    | (3,215)    |
| Net cash provided by financing activities   | 41,171     | 44,530     | 10,239     |
| <b>EFFECT OF FOREIGN EXCHANGE RATE ON CASH</b>  | 1,884      | 215        | 168        |
| <b>NET (DECREASE) INCREASE IN CASH</b>  | (7,924)    | 15,512     | 1,187      |
| <b>CASH, beginning of period</b>  | 19,292     | 3,780      | 2,593      |



|                     |           |           |          |
|---------------------|-----------|-----------|----------|
| CASH, end of period | \$ 11,368 | \$ 19,292 | \$ 3,780 |
|---------------------|-----------|-----------|----------|

**Table of Contents****American Apparel, Inc. and Subsidiaries****Consolidated Statements of Cash Flows (Continued)****(Dollars in Thousands)****For the Years ended December 31, 2008, 2007, and 2006**

|   | 2008      | 2007       | 2006       |
|---|-----------|------------|------------|
| <b>RECONCILIATION OF NET INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b> |           |            |            |
| Net income (loss)   | \$ 14,112 | \$ 15,478  | \$ (1,606) |
| Depreciation and amortization   | 20,844    | 13,306     | 10,904     |
| Imputed interest on stockholder loans   |           | 577        | 277        |
| Stock-based compensation  | 12,625    |            |            |
| Impairment charge   | 644       | 252        | 252        |
| Foreign currency transaction loss (gain)  | 621       | (722)      | (601)      |
| Inventory (recovery) reserve  | (1,731)   | 537        | 4,012      |
| Bad debt expense (recovery)   | 598       | (313)      | 1,077      |
| Deferred taxes  | (6,212)   | (6,913)    | (456)      |
| Deferred rent   | 7,746     | 2,594      | 2,094      |
| Changes in cash due to changes in operating assets and liabilities                                |           |            |            |
| Trade accounts receivables  | (816)     | (499)      | (93)       |
| Other receivables   | (374)     |            |            |
| Inventories   | (44,630)  | (22,158)   | (13,311)   |
| Prepaid expenses and other current assets   | (2)       | (2,298)    | (160)      |
| Other assets  | (8,053)   | (1,714)    | (4,616)    |
| Accounts payable  | 17,482    | (15,835)   | 10,084     |
| Accrued expenses  | 6,196     | 8,503      | (1,290)    |
| Income taxes payable  | 2,121     | 3,767      | 1,103      |
| Net cash provided by (used in) operating activities   | \$ 21,171 | \$ (5,438) | \$ 7,670   |
| <b>NON-CASH INVESTING AND FINANCING ACTIVITIES</b>  |           |            |            |
| Property and equipment acquired under capital leases  | \$ 1,092  | \$ 4,614   | \$ 2,156   |
| Liabilities assumed under Endeavor Acquisition  |           | 1,411      |            |
| Reclassification of advances to stockholders  |           | 553        |            |
| Issuance of warrants to lender  | 1,021     |            |            |

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

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**American Apparel, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Dollar and Shares in Thousands, except per share amounts)**

**For the Years Ended December 31, 2008, 2007 and 2006**

**NOTE 1 Organization and Business**

American Apparel, Inc. (the Registrant) was incorporated in Delaware on July 22, 2005 as Endeavor Acquisition Corporation, a blank check company formed to serve as a vehicle for the acquisition of an operating business. The Registration Statement for the Registrant's initial public offering (Offering) was declared effective December 15, 2005. The Registrant consummated the Offering on December 21, 2005 and received net proceeds of approximately \$113,500. In January 2006, the underwriter exercised the overallotment option generating an additional \$8,840 of net proceeds. Substantially all of the net proceeds of the Offering were intended to be generally applied toward consummating a business combination with an operating company. American Apparel (defined below) was subsequently identified as this operating company.

On December 18, 2006, the Registrant entered into an agreement and plan of reorganization (Agreement) by which it ultimately acquired American Apparel. On November 6, 2007, the Registrant entered into an amended Acquisition Agreement (Amended Agreement) with American Apparel whereby American Apparel, Inc. (AA), American Apparel Canada Wholesale Inc. and American Apparel Canada Retail Inc. (collectively CI Companies) became wholly owned subsidiaries of the Registrant. Upon the completion of the merger with AA and CI Companies on December 12, 2007, the Registrant changed its name to American Apparel, Inc. AA and CI Companies are collectively referred to as American Apparel and the consolidated entity, including the Registrant, is collectively referred to as the Company. For accounting purposes, this business combination (Merger) has been treated as a reverse merger.

The Company is a vertically-integrated manufacturer, distributor, and retailer of fashion essentials for men, women and children. The Company sells its products through a wholesale distribution channel supplying t-shirts and other casual wear to distributors and screen printers, as well as direct to customers through retail stores located in the United States and internationally. In addition, the Company operates an online retail e-commerce website.

**NOTE 2 Completed Merger**

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

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

At the Closing, 8,064 shares of the Company's common stock issued to Dov Charney were placed in escrow until the later of (a) December 12, 2008, the date of the first anniversary of the Closing and (b) the thirtieth day after the date that the Company files its Annual Report on Form 10-K for the year ended December 31, 2007 (which report was filed March 17, 2008), as a fund for the payment of indemnification claims that may be made

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by the Company as a result of any breaches of AA's covenants, representations and warranties in the Agreement and certain lawsuits to which AA is a party. The Company's right to bring a claim for indemnification expired on December 12, 2008 and those shares are no longer subject to the escrow.

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

*Basis of Presentation and Accounting Treatment of the Merger*

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

Additionally, AA and CI Companies have been under common control since each of the entities' inception. In conjunction with the Merger, the two entities were consolidated in a manner similar to a pooling of interests. Accordingly, AA and CI Companies were consolidated retroactively to the earliest period presented, using the historical cost basis of each entity.

In the consolidated statement of stockholders' equity, in addition to reflecting the common control merger retroactive to the earliest period presented, the recapitalization of the number of shares of common stock attributable to the American Apparel stockholders is also reflected retroactive to the earliest period presented. Accordingly, the number of shares presented as outstanding as of the earliest period presented total 48,390, consisting of the 37,258 issued to Dov Charney, and the 11,132 equivalent number of shares assigned to Sang Ho Lim. Sang Ho Lim's shares were determined by dividing the \$67,903 (\$121,589/19,933) he received in cash by the \$6.10 net tangible book value per share of the Registrant as of the Closing. These shares were also used to calculate the Company's earnings (loss) per share for all periods prior to the Merger.

**NOTE 3 Summary of Significant Accounting Policies**

*Liquidity Matters*

Over the past year, the Company's growth has been funded through a combination of borrowings from related and unrelated parties, bank debt and lease financing.

As of December 31, 2008, the Company had (i) approximately \$11.4 million in unrestricted cash, (ii) \$12.1 million available and \$49.4 million outstanding under the revolving credit facility, dated July 2, 2007, with Bank of America, N.A. and the lenders party thereto (the BofA Credit Agreement), and (iii) \$51.0 million of borrowings outstanding under its credit agreement, dated January 18, 2007, with SOF Investments, L.P. Private IV (SOF) and, such credit agreement, the SOF Credit Agreement). See Note 10 Long-term Debt.

On March 13, 2009, the Company and Lion Capital LLP (Lion) entered into (i) a Credit Agreement (the Lion Credit Agreement) among the Company, in its capacity as Borrower, certain subsidiaries of the Company, in their capacity as Facility Guarantors, Lion Capital LLP, in its capacity as administrative agent and collateral agent, Lion Capital (Guernsey) II Limited (Lion), as Initial Lender, and the other lenders from time to time party thereto, and an Investment Agreement (the Investment Agreement) between the Company and Lion. Pursuant to the Lion Credit Agreement, Lion made term loans to the Company in an aggregate principal amount

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equal to \$80,000, of which \$5,000 of such loan constitutes a fee paid by the Company upon the terms and conditions set forth in the Lion Credit Agreement. The Company used a portion of the proceeds of the financing to repay in full the outstanding amount under the SOF Credit Agreement. The remaining portion of the proceeds were used to repay a portion of the promissory notes due to Dov Charney, the Company's Chairman of the Board of Directors, Chief Executive Officer and President, as described below, to reduce the outstanding revolver balance under the BofA Credit Agreement, and to pay fees related to the transaction. Pursuant to the Investment Agreement, the Company issued to Lion a seven-year warrant (the Lion Warrant), which is exercisable at any time during its term, to purchase an aggregate of 16,000 shares of the Company's common stock at an exercise price of \$2 per share upon the terms and conditions set forth in the Investment Agreement.

### *Principles of Consolidation and Basis of Presentation*

The consolidated financial statements include the accounts of American Apparel, Inc. and its direct and indirect wholly-owned subsidiaries (see Note 1). All intercompany accounts and transactions have been eliminated upon consolidation.

### *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The most significant estimates include: sales returns and other allowances, allowance for doubtful accounts, inventory valuation and obsolescence, valuation and recoverability of long-lived intangible assets including the values assigned to acquired intangible assets, goodwill, property and equipment, income taxes; valuation of warrants; and accruals for the outcome of current litigation.

On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results could differ from those estimates.

### *Earnings per Share*

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

The effect of the Merger has been given retroactive application in the EPS calculation (see Note 2, Basis of Presentation and Accounting Treatment of the Merger). The common stock issued and outstanding with respect to the pre-Merger stockholders of the Registrant has been included in the EPS calculation since the Closing date of the Merger. All of the Registrant's outstanding warrants (the Endeavor Warrants) which were issued in the initial public offering of Endeavor Acquisition Corp. and underwriter's purchase option are reflected in the diluted EPS calculation, using the treasury stock method, commencing with the Closing date of the Merger.

The impact of one million shares of common stock underlying the SOF Warrant (Note 10) is excluded from the EPS calculation because the effect would be anti-dilutive. The impact of the 16,000 shares of common stock underlying the Lion Warrant are also not included because the Lion Warrant was issued after December 31, 2008

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The following provides a reconciliation of information used in calculating EPS for the years ended December 31, 2008, 2007 and 2006:

|  | 2008   | 2007   | 2006   |
|--|--------|--------|--------|
| Weighted average shares outstanding used in Basic EPS        | 69,490 | 48,890 | 48,390 |
| Dilutive effect of warrants and underwriters purchase option | 827    | 524    |        |
| Weighted average shares outstanding for Diluted EPS          | 70,317 | 49,414 | 48,390 |

*Share-Based Compensation*

On December 12, 2007, the stockholders approved the 2007 Performance Equity Plan ( the 2007 Plan ). The 2007 Plan authorizes the granting of awards, the exercise of which would allow up to an aggregate of 7,710 shares of the Company s common stock to be acquired by the holders of such awards. The purpose of the 2007 Plan is to enable the Company s compensation committee to offer its employees, officers, directors and consultants whose past, present and/or potential contributions to the Company have been, are or will be important to the success of the Company, an opportunity to acquire a proprietary interest in the Company. The 2007 Plan provides for various types of incentive awards including: incentive stock options, non-qualifying stock options, restricted stock and stock appreciation rights. The 2007 Plan will enable the compensation committee to determine virtually all terms of each grant, which will allow the Company to respond to changes in compensation practices, tax laws, accounting regulations and the size and diversity of its business. On November 20, 2008, the stockholders approved an amendment to the 2007 Plan to (i) increase the number of shares of common stock reserved for issuance thereunder by 3,290 shares and (ii) to increase the maximum number of shares of common stock that may be granted as awards thereunder to any one individual in any one calendar year from 200 to 2,500.

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

*Revenue Recognition*

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

The Company recognizes the sales from gift cards, gift certificates and store credits as they are redeemed for merchandise. Prior to redemption, the Company maintains an unearned revenue liability for gift cards, gift certificates and store credits until the Company is released from such liability. The Company s gift cards, gift certificates and store credits do not have expiration dates. The unearned revenue for gift cards, gift certificates and store credits are recorded in accrued expenses in the amount of \$2,672 and \$1,816 at December 31, 2008 and 2007, respectively.

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### *Sales Returns and Allowances*

Allowances For Sales Returns The Company analyzes sales returns in accordance with SFAS No. 48 Revenue Recognition When Right of Return Exists ( SFAS 48 ). The Company is able to make reasonable and reliable estimates of product returns for its wholesale, online product sales and retail store sales based on the Company's past history. The Company also monitors the buying patterns of the end-users of its products based on sales data received by its retail outlets. Estimates for sales returns are based on a variety of factors including actual returns based on expected return data communicated to it by customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. Actual results could differ from those estimates.

As with any set of assumptions and estimates, there is a range of reasonably likely amounts that may be calculated for each allowance above. However, the Company believes that there would be no significant difference in the amounts reported using other reasonable assumptions than what was used to arrive at each allowance. The Company regularly reviews the factors that influence its estimates and, if necessary, makes adjustments when it believes that actual product returns, credits and other allowances may differ from established reserves. Actual experience associated with any of these items may be significantly different than the Company's estimates.

### *Concentrations of Credit Risk*

Financial instruments which potentially subject the Company to credit risk consist primarily of cash (the amounts of which may, at times, exceed Federal Deposit Insurance Corporation limits on insurable amounts) and trade accounts receivable, relating substantially to the Company's U.S. wholesale segment. The Company mitigates its risk by investing in or through major financial institutions. The Company had approximately \$7,675 and \$5,939 held in foreign banks at December 31, 2008, and 2007, respectively.

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

### *Cash*

The Company's cash balances represent unrestricted cash on deposit held at banks.

### *Trade Accounts Receivable*

Accounts receivable primarily consists of trade receivables, including amounts due from credit card companies, net of allowances. Amounts due from credit card, debit card and electronic benefit transfer transactions as of December 31, 2008, and 2007, were approximately \$1,153 and \$1,089, respectively.

### *Inventories*

Inventories are stated at the lower of cost or market. Cost is primarily determined on the first-in, first-out (FIFO) method. The cost elements of inventories include materials, labor and overhead. For the years ended December 31, 2008, 2007, and 2006, respectively, no one supplier provided more than 10% of the Company's raw material purchases.

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The Company identifies potentially excess and slow-moving inventories by evaluating turn rates, inventory levels and other factors. Excess quantities are identified through evaluation of inventory aging, review of inventory turns and historical sales experiences. The Company provides lower of cost or market reserves for such identified excess and slow-moving inventories. At December 31, 2008 and 2007, the Company had a reserve for slow-moving inventories of \$2,498 and \$4,284, respectively. The Company's reserve for slow-moving inventories decreased \$1,786 for the year ended December 31, 2008.

The Company establishes a reserve for inventory shrinkage for each of its retail locations. The reserve is based on the historical results of physical cycle counts. The Company has a reserve for inventory shrinkage and obsolescence in the amount of \$1,120, \$1,065 and \$528 for the years ended December 31, 2008, 2007 and 2006, respectively.

### *Property and Equipment*

Property and equipment are carried at cost. Depreciation is provided on a straight-line basis over the estimated useful lives of the related assets. The costs of normal maintenance and repairs are charged to expense in the year incurred. Expenditures which significantly improve or extend the life of an asset are capitalized and depreciated over the asset's remaining useful life. Amortization of leasehold improvements is computed using the straight-line method over the shorter of the estimated useful lives of the related assets or the lease term. Upon sale or disposition, the related cost and accumulated depreciation are removed from the accounts and the resulting gain or loss, if any, is reflected in operations.

### *Goodwill and Other Intangible Assets*

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

Other definite lived intangibles are amortized on a straight-line basis over periods not exceeding 10 years.

### *Impairment of Long-Lived Assets*

The Company follows the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS 144 requires evaluation of the need for an impairment charge relating to long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write down to a new depreciable basis is required. If required, an impairment charge is recorded based on an estimate of future discounted cash flows. For the years ended December 31, 2008, 2007 and 2006, the Company recognized impairment charges of \$644, \$252 and \$252, respectively, on assets to be held and used. The impairment charges related primarily to leasehold improvements and furniture and fixtures for certain North American retail stores and are included in the Consolidated Statements of Operations under the caption *Operating Expenses*.



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*Foreign Currency*

The financial statements of international subsidiaries are translated into U.S. Dollars using the exchange rate at each balance sheet date for assets and liabilities and an average exchange rate for each period for revenues, expenses, gains and losses. Foreign currency transaction gains and losses are charged or credited to operations as incurred. Where the local currency is the functional currency (which is determined based on management's judgment and involves consideration of all relevant economic facts and circumstances affecting the subsidiary) translation adjustments are recorded as a separate component of stockholders' equity. The Company recognized a foreign currency transaction loss of \$621 in 2008 and foreign currency transaction gains \$722 and \$601 in 2007 and 2006, respectively.

*Taxes*

As a result of the Merger, AA was required to convert from a Subchapter S Corporation to a C Corporation as of the Closing on December 12, 2007. As a Subchapter S Corporation, U.S. federal and certain state income taxes were the responsibility of the Company's stockholders. Accordingly, the income taxes were not reflected in the Company's financial statements.

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

The unaudited pro forma computation of income tax included in the Consolidated Statements of Operations, represents the tax effects that would have been reported had the Company been subject to U.S. federal and state income taxes as a corporation for the years ended December 31, 2007 and 2006. Pro forma taxes are based upon the statutory income tax rates and adjustments to income for estimated permanent differences occurring during each period. Actual rates and expenses could have differed had the Company actually been subject to U.S. federal and state income taxes for all periods presented. Therefore, the unaudited pro forma amounts are for informational purposes only and are intended to be indicative of the results of operations had the Company been subject to U.S. federal and state income taxes as a corporation for the years ended December 31, 2007 and 2006.

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

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company estimates the degree to which tax assets and credit carryforwards will result in a benefit based on expected profitability by tax jurisdiction. A valuation allowance for such tax assets and loss carryforwards is provided when it is determined that such assets will more likely than not go unused. If it becomes more likely than not that a tax asset will be used, the related valuation allowance on such assets would be reversed. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

The Company accounts for the presentation of taxes in accordance with Emerging Issue Task Force ( EITF ) Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities

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Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) ( EITF 06-3 ). The EITF reached a consensus that the scope of the Issue includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and may include, but is not limited to, sales, use, value added, and some excise taxes. The Company currently records its sales net of any value added or sales tax.

### *Fair Value of Financial Instruments*

Financial instruments include cash, trade accounts receivable, other receivables, accounts payable, notes payable and long term debt. The recorded values of cash, trade accounts receivable, other receivables and accounts payable approximate fair value based on their short-term nature. The recorded values of notes payable and long-term debt approximate their fair values, as interest approximates market rates.

### *Advertising, Promotion and Catalog*

The Company expenses the production costs of advertising the first time the advertising takes place. The advertising expenses for the years ended December 31, 2008, 2007 and 2006 amounted to \$18,392, \$12,765 and \$8,138, respectively and were included in Operating Expenses in the Consolidated Statements of Operations. The Company has cooperative advertising arrangements with certain vendors in its U.S. wholesale segment. For the years ended December 31, 2008, 2007 and 2006, cooperative advertising expenses were \$258, \$377 and \$376, respectively.

### *Shipping and Handling Costs*

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

### *Preferred stock*

At December 31, 2008, 2007 and 2006, the Company was authorized to issue 1,000 shares of preferred stock with a par value of \$0.0001 with such designations, voting and other rights and preferences as may be determined from time to time by the Board of Directors. There were no shares issued or outstanding at December 31, 2008, 2007 or 2006. Shares may be issued in one or more series.

### *Deferred Rent, Rent Expense and Tenant Allowances*

The Company occupies its retail stores and combined corporate office, manufacturing, and distribution center under operating leases generally with terms of one to ten years. Some leases contain renewal options for periods ranging from five to fifteen years under substantially the same terms and conditions as the original leases. Most of the store leases require payment of a specified minimum rent; a contingent rent based on a percentage of the store's net sales in excess of a specified threshold, plus defined escalating rent provisions. The Company straight-lines and recognizes its rent expense over the term of the lease (including probable lease renewals), plus the construction period prior to occupancy of the retail location, using a mid-month convention. Also included in rent expense are payments of real estate taxes, insurance and certain common area and maintenance costs in addition to the future minimum operating lease payments. Certain lease agreements provide for the Company to receive lease inducements or tenant allowances from landlords to assist in the financing of certain property. These inducements are recorded as a deferred credit and amortized as a reduction of rent expense over the term of the related lease.

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### *Contingencies*

Certain conditions may exist as of the date the consolidated financial statements are issued, which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company assesses such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Company or unasserted claims that may result in such proceedings, the Company evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in the Company's consolidated financial statements. If the assessment indicates that a potentially material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed.

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed.

### *Start-up Costs*

The Company expenses as incurred all retail store start-up and organization costs, including travel, training, recruiting, salaries and other operating costs.

### *Web Site Development Costs*

The Company capitalizes applicable costs incurred during the application and infrastructure development stage and expenses incurred during the planning and operating stage. As of December 31, 2008 and 2007, the Company had capitalized website development costs of \$697 and \$7, respectively, which are included in property and equipment in the accompanying Consolidated Balance Sheets.

### *Self-insurance accruals*

The Company self-insures a significant portion of expected losses under the workers' compensation and healthcare benefits program. Accrued liabilities are recorded based on the Company's estimates of the ultimate costs to settle incurred claims, both reported and unreported.

### *Environmental Remediation Costs*

The Company accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Costs of future expenditures for environmental remediation obligations are not discounted to their present value. As of December 31, 2008 and 2007, the Company did not have any accrued losses for environmental remediation obligations.

### *Comprehensive Income*

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

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*Accounting Pronouncements-Newly Issued and Adopted*

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

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

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

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

In February 2008, the FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. This FSP defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008 and the interim periods within those fiscal years for items within the scope of this FSP. The Company has evaluated this new FSP and has determined that it will not have a significant impact on the determination or reporting of our financial results.

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

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

In June 2008, the FASB ratified the consensus reached by the EITF on Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock* ( EITF No. 07-5 ). EITF No. 07-5 provides guidance for determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity s own stock. EITF No. 07-5 applies to any freestanding financial instrument or embedded feature that has all of the characteristics of a derivative or freestanding instrument that is potentially settled in an entity s own stock. To meet the definition of indexed to own stock, an instrument s contingent exercise provisions must not be based on (a) an observable market, other than the market for the issuer s stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer s own operations, and the variables that could affect the settlement amount must be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. EITF No. 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company will adopt EITF No. 07-5 as of January 1, 2009.

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

**NOTE 4 Business Acquisitions**

On December 1, 2007 the Company entered into an agreement with an unrelated third party to assume a lease and purchase all of the assets of a garment sewing, dyeing and finishing plant. Purchase of these assets added garment dyeing capability to the Company s production process. The purchase included the assumption of the lease for the facility as well as the purchase of all of the tangible personal property at the plant. The Company accounted for this acquisition under the purchase method of accounting in accordance with SFAS No 141, *Business Combinations* . Under the purchase method the total purchase price has been allocated to the tangible assets acquired, based upon their estimated fair values. These Consolidated Financial Statements include the results of operations of this business since December 1, 2007.

The purchase price of the garment sewing, dyeing and finishing equipment amounted to \$1,600. The Company made payments totaling \$1,600 to the unrelated third party during December 2007.

On May 9, 2008 the Company completed an asset purchase with an unrelated third party to assume a lease and purchase all of the assets of a fabric dyeing and finishing plant. The purchase included the assumption of the lease for the facility as well as the purchase of all of the tangible personal property at the plant. The Company paid \$3,500 for the assumption of the lease and purchase of machinery and equipment. The acquisition of these assets was accounted for under the purchase method of accounting in accordance with SFAS No. 141 *Business Combinations*. The cost to acquire these assets was allocated to the respective assets and liabilities acquired based on their estimated fair values at the closing date.

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At December 31, 2008, the allocation of the cost to acquire these assets were as follows:

|                              |                 |
|------------------------------|-----------------|
| Property and equipment       | \$ 2,918        |
| Goodwill                     | 956             |
| <b>Total assets acquired</b> | <b>3,874</b>    |
| Total liabilities assumed    | 374             |
| <b>Net assets acquired</b>   | <b>\$ 3,500</b> |

Pro-forma financial information is not provided for these acquisitions as their impact was not material individually or in the aggregate to the Company's consolidated financial statements.

**NOTE 5 Inventories, net**

The components of inventories at December 31 are as follows:

|   | 2008       | 2007       |
|---|------------|------------|
| Raw materials   | \$ 41,648  | \$ 27,703  |
| Work in process                                       | 1,450      | 3,238      |
| Finished goods  | 108,674    | 80,842     |
|   | 151,772    | 111,783    |
| Less reserve for inventory shrinkage and obsolescence | (3,618)    | (5,349)    |
| Total, net of reserves                                | \$ 148,154 | \$ 106,434 |

**NOTE 6 Property and Equipment**

The components of property and equipment at December 31 are as follows:

|   | 2008       | 2007      | Depreciation and<br>Amortization Period<br>(Years) |
|---|------------|-----------|--|
| Machinery and equipment                   | \$ 38,556  | \$ 24,120 | 5-7 years  |
| Furniture and fixtures                    | 28,408     | 19,731    | 5 years  |
| Computers and software                    | 19,520     | 11,566    | 3-5 years  |
| Automobiles and light trucks              | 1,176      | 686       | 3 years  |
| Leasehold Improvements                    |            |           | Shorter of the life of<br>lease or useful life     |
|   | 72,840     | 40,284    |  |
| Buildings                                 | 2,550      | 1,544     | 25 Years   |
| Construction in progress                  | 3,861      | 3,268     |  |
|   | 166,911    | 101,199   |  |
| Accumulated depreciation and amortization | (54,503)   | (36,331)  |  |
| Total                                     | \$ 112,408 | \$ 64,868 |  |

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For the years ended December 31, 2008, 2007, and 2006 depreciation and amortization expense relating to property and equipment (including capitalized leases) was \$20,197, \$13,033 and \$10,829, respectively. At December 31, 2008 and 2007, property and equipment includes \$11,370 and \$8,259, for assets held under capital leases, respectively. Accumulated amortization for these capital leases at December 31, 2008 and 2007 was \$6,921, and \$4,382, respectively.

**Table of Contents****NOTE 7 Goodwill and Other Intangible Assets**

Goodwill of \$1,906 is assigned to the U.S. wholesale segment and is related to the acquisition of American Apparel Dyeing & Finishing, Inc. on June 2, 2005 and American Apparel Garment and Dyeing, Inc. on May 9, 2008. The carrying amount of goodwill was \$1,906 and \$950 as of December 31, 2008 and 2007, respectively.

Intangible Asset, net

The carrying amounts of intangible assets at December 31 are as follows:

|                                   | 2008<br>Carrying<br>Amount | 2007<br>Carrying<br>Amount | Amortization<br>Period<br>(Years) |
|-----------------------------------|----------------------------|----------------------------|-----------------------------------|
| Definite lived intangible assets: |                            |                            |                                   |
| Deferred Financing Costs          | \$ 5,058                   | \$ 1,603                   | Life of loan                      |
| Key money store leases            | 2,736                      | 719                        | Life of lease                     |
| Broker and finder fees            | 1,656                      |                            | Life of lease                     |
| Lease rights                      | 1,774                      | 998                        | Life of lease                     |
|                                   | 11,224                     | 3,320                      |                                   |
| Accumulated Amortization          | (1,138)                    | (1,034)                    |                                   |
| Total                             | \$ 10,086                  | \$ 2,286                   |                                   |

Deferred financing costs represent costs incurred in connection with the issuance of certain indebtedness and were capitalized as deferred costs and are being amortized over the term of the related indebtedness. The Company incurred related amortization expense of \$1,030 and \$685 for the years ended December 31, 2008 and 2007, respectively, which is recorded to interest expense.

Key money is the amount of funds paid to a landlord or tenant to acquire the rights of tenancy under a commercial property lease for a certain property. Key money represents the right to lease with an automatic right of renewal. This right can be subsequently sold by the Company or can be recovered should the landlord refuse to allow the automatic right of renewal to be exercised. Key money is amortized over the respective lease terms.

Lease rights are costs incurred to acquire the right to lease a specific property. A majority of our lease rights are related to premiums paid to landlords. Lease rights are recorded at cost and are amortized over the estimated useful term of the respective leases. Property lease terms are generally for ten years.

Aggregate amortization expense of other definite lived intangible assets included in the Consolidated Statements of Operations under the caption Operating Expenses for the years ended December 31, 2008, 2007 and 2006 was approximately \$647, \$273 and \$75, respectively.

As of December 31, 2008, estimated amortization expense for each of the five succeeding years is as follows:

|      | Amount   |
|------|----------|
| 2009 | \$ 4,674 |
| 2010 | 1,506    |
| 2011 | 1,461    |
| 2012 | 915      |
| 2013 | 538      |



**Table of Contents****NOTE 8 Other Assets**

The components of other assets at December 31 are as follows:

|                               | 2008      | 2007     |
|-------------------------------|-----------|----------|
| Lease security deposits       | \$ 11,284 | \$ 8,152 |
| Worker's Compensation deposit | 314       |          |
| Other                         | 1,605     | 1,108    |
| Total                         | \$ 13,203 | \$ 9,260 |

**NOTE 9 Accrued Expenses**

The components of accrued expenses at December 31 are as follows:

|   | 2008      | 2007      |
|---|-----------|-----------|
| Accrued compensation and related taxes        | \$ 5,571  | \$ 4,834  |
| Worker's Compensation self-insurance reserves | 7,433     | 4,838     |
| Sales tax, value added tax, property taxes    | 2,494     | 1,700     |
| Accrued interest                              | 174       | 185       |
| Gift cards / store credits                    | 2,672     | 1,817     |
| Accrued Bonuses                               |           | 2,500     |
| Other   | 7,945     | 6,003     |
| Total   | \$ 26,289 | \$ 21,877 |

**NOTE 10 Long-term Debt**

Long-term debt at December 31 consists of the following:

|   | 2008      | 2007      |
|---|-----------|-----------|
| <b>Credit Line Facilities</b>                                     |           |           |
| Revolving Credit Facility, maturing July 2012 (a)                 | \$ 49,401 | \$ 47,402 |
| Revolving Credit Facility, due on demand (b)                      | 409       | 1,170     |
|   | \$ 49,810 | \$ 48,572 |
| <b>Term Loans and Notes Payable</b>                               |           |           |
| Term loan with private investment firm, refinanced March 2009 (c) | 51,000    | 51,000    |
| Other   | 558       | 1,000     |
|   | 51,558    | 52,000    |
| Total Long-Term Debt  | 101,368   | 100,572   |
| Less current portion of debt                                      | (1,380)   | (99,930)  |
| Long-Term Debt, net of current portion                            | \$ 99,988 | \$ 642    |

- (a) On July 2, 2007, the Company replaced its secured revolving credit facility of \$62,500 with an increased revolving credit facility (the BofA Credit Agreement ) of \$75,000 from a new bank (the Bank ). The BofA Credit Agreement was to expire on March 21, 2009, the date thirty days prior to the April 20, 2009 maturity date of the loan agreement with SOF Investments L.P. Private IV ( SOF ), as discussed below, unless the SOF loan was refinanced on terms acceptable to the Bank. The SOF loan was refinanced on March 13, 2009 (see Note 20). As such, the BofA Credit Agreement will now mature on July 2, 2012. In accordance with SFAS No. 6, Classification of Short-Term Obligations Expected to Be Refinanced, an amendment of ARB No. 43, Chapter 3A, the outstanding loan balance of \$49,401 at December 31, 2008 is reflected as a long-term liability in the accompanying consolidated balance sheet.

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Borrowings under the BofA Credit Agreement are subject to certain advance provisions established by the Bank and are collateralized by substantially all of the Company's assets. Interest under the agreement is at LIBOR (2.59% at December 31, 2008) plus 4.5% or the Bank's prime rate (which rate can in no event be lower than LIBOR plus 2.5% per annum) (3.25% at December 31, 2008) plus 2.5%, at the Company's option. The average borrowings under the Company's revolving credit facility during the year ended December 31, 2008 were \$51,438.

Periodically, the Company has been in default of certain provisions of the BofA Credit Agreement. The Company has amended the BofA Credit Agreement on five occasions to address various matters, most recently on December 19, 2008. As a precondition to the effectiveness of the fifth amendment, Dov Charney, was required to make a subordinated loan to the Company in the amount of \$2,500 (see Note 11). Significant covenants included in the BofA Credit Agreement, as amended, include limiting the Company's capital expenditures to \$9,262 in the first quarter of 2009 and to approximately \$8,500 for the remainder of 2009. The Company was in compliance with the financial covenants at December 31, 2008.

(b) As of December 31, 2008, the CI Companies had a line of credit with a bank that provided for borrowings up to C\$4,000 due on demand, bearing interest at the bank's prime rate (3.5% at December 31, 2008 and 6.0% at December 31, 2007) plus 1.00% per annum payable monthly. This line of credit is secured by two \$7,500 moveable hypothecs, which provide for a charge on the CI Companies' accounts receivable, inventory and certain other moveable assets and by Section 427 Security under the Bank Act of Canada on inventory. The credit agreement contains various covenants which require the CI Companies to maintain certain financial ratios and commitments as defined by the bank. At December 31, 2008, the CI Companies were not in compliance with certain of the covenants. Subsequent to year end, the CI Companies signed a new banking agreement with its bank and the U.S. affiliate has subrogated its note in the amount of \$6,527 in favor of the bank. With this subrogation, the CI Companies are in compliance with the bank covenants.

(c) As of December 31, 2008, the Company had a term loan agreement with SOF originally dated January 18, 2007 with a balance of \$41,000, which was subsequently increased to \$51,000 on July 22, 2007. Indebtedness under the agreement bore interest at 16% per annum, payable monthly and was to mature on April 20, 2009. The SOF loan was fully repaid on March 13, 2009 from the proceeds of a term loan with a new lender (see Note 20). In accordance with SFAS No. 6, the outstanding term loan balance of \$51,000 at December 31, 2008 is reflected as a long-term liability in the accompanying consolidated balance sheet. The SOF term loan agreement required the Company to meet certain financial covenants. In the event the Company was in default under the agreement, the interest rate increased to 21% per annum and SOF had the right to demand payment in full of all outstanding indebtedness. The SOF term loan was collateralized by substantially all assets of the Company subject to prior liens with respect to any such assets under the Credit Agreement with the Bank.

The covenants included in the SOF Loan were substantially similar to the covenants included in the BofA Credit Agreement with the Bank (see above). The Company amended the SOF term loan agreement nine times, most recently on December 19, 2008. In connection with the ninth amendment, the Company paid SOF a fee of \$2,550 and issued to SOF a warrant (the "SOF Warrant") to purchase 1,000 shares of Company common stock at an exercise price of \$3.00 per share, which SOF Warrant is exercisable at any time during its term (see Note 15 for a description of the terms and accounting for the SOF Warrant). Under the terms of the ninth amendment, if the Company were to fail to raise \$16 million of financing by March 13, 2009, the Company would be required to issue to SOF warrants to purchase an additional 2,000 shares of the Company's common stock on the same terms as the SOF Warrants. As discussed above, the SOF Loan was repaid on March 13, 2009, and the additional SOF Warrants were not required to be issued.

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Required principal payments of (reflecting the SOF loan refinancing) long-term debt are as follows:

| <b>Year Ending December 31,</b> |            |
|---------------------------------|------------|
| 2009                            | \$ 52,380  |
| 2010                            | 559        |
| 2011                            | 493        |
| 2012                            | 47,936     |
| 2013                            | 80,000     |
|                                 | \$ 181,368 |

**NOTE 11 Subordinated Notes Payable to Related Parties**

During the year ended December 31, 2008, the Company repaid outstanding loan balances to the Company's CEO. Loans from the CEO were reduced from \$3,804 and \$2,232 at December 31, 2007 to \$0 and \$792 at December 31, 2008, respectively. Both loans bear interest at 6% commencing December 12, 2007 and were scheduled to mature in 2012. On December 19, 2008, the Company received \$2,500 from the CEO in exchange for a promissory note scheduled to mature in January 2013, which bears interest at 6%, payable in kind. Prior to December 12, 2007, related party loans were non-interest bearing and without terms of repayment. For the years ended December 31, 2008, December 31, 2007 and December 31, 2006, interest expense was \$346, \$277 and \$157, respectively. For the periods prior to December 12, 2007, interest has been imputed at an average rate of 14% and was credited as an addition to paid-in capital.

**NOTE 12 Capital Lease Obligations**

The Company leases certain equipment under capital lease arrangements expiring at various times through 2013. The assets and liabilities under capital leases are recorded at the lower of the present values of the minimum lease payments or the fair values of the assets. The interest rates pertaining to these capital leases range from 6.1% to 17.9% (average interest rate is 11.7%).

Minimum future payments under these capital leases at December 31 are:

| <b>Year Ending December 31,</b>     |          |
|-------------------------------------|----------|
| 2009                                | \$ 3,011 |
| 2010                                | 1,738    |
| 2011                                | 262      |
| 2012                                | 93       |
| 2013                                | 37       |
| Total future minimum lease payments | 5,141    |
| Less: amount representing interest  | (539)    |
| Net minimum lease payments          | 4,602    |
| Current portion                     | 2,616    |
| Long-term portion                   | \$ 1,986 |

**Table of Contents****NOTE 13 Income Taxes**

For financial reporting purposes, income (loss) before income taxes includes the following components for the years ended December 31, 2008, 2007, and 2006:

|               | 2008      | 2007      | 2006       |
|---------------|-----------|-----------|------------|
| United States | \$ 4,610  | \$ 968    | \$ (5,149) |
| Foreign       | 16,757    | 14,315    | 5,117      |
|               | \$ 21,367 | \$ 15,283 | \$ (32)    |

The (benefits) provisions for income taxes for the years ended December 31, 2008, 2007 and 2006 are as follows:

|  | 2008     | 2007     | 2006     |
|--|----------|----------|----------|
| <b>Current:</b>                            |          |          |          |
| Federal                                    | \$ 2,198 | \$ 92    | \$       |
| State                                      | 1,500    | 641      | 237      |
| Foreign                                    | 7,192    | 5,985    | 1,793    |
| Subtotal current                           | 10,890   | 6,718    | 2,030    |
| <b>Deferred:</b>                           |          |          |          |
| Federal                                    | (2,579)  | (5,619)  |          |
| State                                      | (987)    | (1,231)  | (258)    |
| Foreign                                    | (69)     | (63)     | (198)    |
| Subtotal deferred                          | (3,635)  | (6,913)  | (456)    |
| Total (benefit) provision for income taxes | \$ 7,255 | \$ (195) | \$ 1,574 |

The following is a reconciliation of taxes at the U.S. federal statutory rate and the effective tax rate:

|  | 2008     | 2007     | 2006     |
|--|----------|----------|----------|
| Taxes at the statutory federal tax rate of 35%         | \$ 7,478 | \$ 5,349 | \$ (43)  |
| Reduced federal tax rate for S Corporations            |          | (5,124)  | 43       |
| State tax, net of federal benefit                      | (7,817)  | (3,467)  | (2,853)  |
| Change in valuation allowance                          | 8,132    | 3,765    | 2,833    |
| Change in tax rates due to conversion to C Corporation | 980      | (6,205)  |          |
| Federal general business tax credits                   | (829)    |          |          |
| Domestic production deduction                          | (495)    |          |          |
| Foreign taxes  | (266)    | 5,461    | 1,594    |
| Other  | 72       | 26       |          |
| Total (benefit) provision for income taxes             | \$ 7,255 | \$ (195) | \$ 1,574 |

As a result of the Merger the Company was required to change from a Subchapter S Corporation to a C Corporation. Accordingly the Company was required to recognize deferred tax assets and liabilities from the expected tax consequences of temporary differences between the book and tax basis of the Company's assets and liabilities at the date of the Merger. This resulted in a one-time deferred tax benefit of \$6,205 being recognized during the year ended December 31, 2007. Upon filing the 2007 tax returns during 2008 the Company determined the deferred tax

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asset recorded at December 31, 2007 should have been \$5,225, resulting in an adjustment to the current provision for income taxes aggregating \$980 for the year ended December 31, 2008.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

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Deferred tax assets and liabilities consist of the following as of December 31, 2008 and 2007:

|  | 2008            | 2007            |
|--|-----------------|-----------------|
| Deferred tax assets:                                     |                 |                 |
| Allowance for doubtful accounts                          | \$ 563          | \$ 735          |
| Deferred rent  | 6,675           | 3,767           |
| Accrued worker's compensation                            | 2,980           | 1,895           |
| Inventories  | 3,788           | 4,018           |
| Accrued liabilities                                      | 620             | 894             |
| California enterprise zone tax credits                   | 18,859          | 10,709          |
| Foreign currency translation loss                        | 1,948           |                 |
| Foreign tax credits                                      |                 | 18              |
| Fixed assets, foreign                                    | 153             | 101             |
| Other  | 549             | 41              |
| <b>Total gross deferred tax assets</b>                   | <b>36,135</b>   | <b>22,178</b>   |
| Less, Valuation allowance                                | (18,859)        | (10,728)        |
| <b>Net deferred tax assets</b>                           | <b>17,276</b>   | <b>11,450</b>   |
| Deferred tax liabilities:                                |                 |                 |
| Prepaid expenses   | (1,580)         | (1,919)         |
| Other  | (48)            | (424)           |
| Fixed assets   | (1,576)         | (1,067)         |
| <b>Total gross deferred tax liabilities</b>              | <b>(3,204)</b>  | <b>(3,410)</b>  |
| <b>Net deferred tax assets and liabilities</b>           | <b>14,072</b>   | <b>8,040</b>    |
| Less, current portion                                    | 5,628           | 4,894           |
| <b>Net long-term deferred tax assets and liabilities</b> | <b>\$ 8,444</b> | <b>\$ 3,146</b> |

At December 31, 2008, the Company has available California state tax credit carryforwards of \$18,859 that may be utilized to offset future California tax liabilities arising from designated enterprise zone areas. The California state tax credits do not expire. The Company believes it is not more likely than not that the California state tax credits will not be utilized in the future. Consequently, the Company has provided valuation allowances of \$18,859 and \$10,709 for the years ended December 31, 2008 and December 31, 2007, respectively.

On January 1, 2007 the Company adopted the provisions of the Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( an Interpretation of FASB No. 109 ( FIN No. 48 ). FIN No. 48 addresses the determination of how tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN No. 48, the Company must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate resolution. The Company did not recognize any additional liabilities for uncertain tax positions as a result of the implementation of FIN No. 48.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

|  | 2008   | 2007   |
|--|--------|--------|
| Gross unrecognized tax benefits at January 1 | \$ 611 | \$ 611 |
| Increases for tax positions in current year  | 326    | 611    |

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|  |        |        |
|--|--------|--------|
| Gross unrecognized tax benefits at December 31 | \$ 937 | \$ 611 |
|--|--------|--------|



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The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant taxing authorities. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the calendar years ended December 31, 2006 through December 31, 2008. During 2008 the Company concluded an Internal Revenue Service audit of the 2005 calendar year tax return. There was no material impact to the Company as a result of the audit. The Company is currently being audited by the Canadian Inland Revenue Service for the years ended December 31, 2005 through December 31, 2007. The audit is still in its initial stages. Management does not expect there to be a material impact to the Company as a result of the audit. The Company and its subsidiaries' state and foreign tax returns are also open to audit under similar statute of limitations for the calendar years ended December 31, 2004 through December 31, 2008. It should be noted that through December 12, 2007, the Company was taxed as an S corporation in the United States and thereafter is taxed as a C corporation in the United States.

The gross unrecognized tax benefits at December 31, 2008 and 2007 are included in income taxes payable. The Company accrues interest on unrecognized tax benefits as a component of income tax expense. Penalties, if incurred, would be recognized as a component of income tax expense. The Company had no such accrued interest or penalties included in the accrued liabilities associated with unrecognized tax benefits as of the date of adoption.

The Company does not provide for U.S. Federal income taxes on the undistributed earnings (\$7,198 at December 31, 2008) of CI Companies which are considered permanently invested outside of the U.S. Upon distribution of the earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable in Canada. Determination of the amount of the unrecognized deferred U.S. income tax liability is not practicable because of the complexities associated with the hypothetical calculation.

Additionally, the Company is subject to tax examinations for payroll, value added, sales-based and other taxes. A number of these examinations are ongoing and, in certain cases, have resulted in assessments from the taxing authorities. Where appropriate, the Company has made accruals for these matters which are reflected in the Company's consolidated financial statements.

**NOTE 14 Related Party Transactions**

In December 2005, the Company entered into an operating lease, which commenced on November 15, 2006, for its knitting facility with a related company, which is partially owned by the Chief Executive Officer of the Company. The monthly lease payments are \$52 and the lease expires in November 2011, with a five year extension, at the option of the Company. Rent expense was \$619, \$598 and \$0 for the years ended December 31, 2008, 2007 and 2006, respectively. Prior to the Merger, the stockholders of AA owned 50% of the building. After the Merger, the Chief Executive Officer owns 25% of the building. Pursuant to an Assignment Agreement executed in December 2007, the Chief Executive Officer transferred 6.25% of his ownership interest in the Company that owns the building to Martin Bailey, the Company's Chief Manufacturing Officer. The value of this assignment is de minimus.

During the years ended December 31, 2007 and 2006, the Company paid management fees charged by the Chief Executive Officer of \$5,302 and \$2,046, respectively. In addition consulting fees charged by an immediate family member of the Chief Executive Officer were \$211 and \$89 for the years ended December 31, 2007 and 2006, respectively.

See Note 11 Subordinated Notes Payable to Related Parties for a description of the loans made by the Chief Executive Officer to the Company.

**Table of Contents****NOTE 15 Stock Transactions**

Pursuant to the 2007 Plan, the Company's seven non-employee directors each received a stock grant (of fully vested shares) following the Closing of the Merger and will receive a stock grant for each year of service thereafter, equal to the number of shares of the Company's common stock having an aggregate market value of \$75 at the date of grant (Note 16). The initial stock grant was approved by the Board on February 6, 2008, subject to the filing and effectiveness of a registration statement on Form S-8, which was filed on April 17, 2008. Pursuant to the Board authorization for the initial stock grant, however, the number of shares awarded to the non-employee directors was to be determined using the highest closing price as of December 12, 2007, February 6, 2008 and April 17, 2008. Consequently, the Company issued to each non-employee director approximately 5 shares of common stock, based upon the December 12, 2007 closing price per share of \$15.60. The compensation expense associated with the share awards is approximately \$432 and is reflected in operating expenses for the year ended December 31, 2008 in the consolidated financial statements, and was based upon the February 6, 2008 closing price of \$12.85 per share.

On August 14, 2008, 1,851 shares of the Company's common stock (fully vested and not subject to any restrictions or conditions) having an aggregate value of \$12,102 were awarded to eligible manufacturing employees and included in cost of sales for the year ended December 31, 2008. Of the \$12,102, approximately \$5,174 was withheld for the payment of employment and withholding taxes and 1,058 shares with an aggregate value of \$6,922 were issued to employees and cash in the amount of \$6 was paid to employees in lieu of the issuance of fractional shares. The net share settlement is deemed to be a repurchase by the Company of its common stock. The value of the stock award was determined based upon the August 14, 2008 closing price per share of \$6.54.

On September 29, 2008, the Company granted approximately 13 shares of the Company's common stock (fully vested and not subject to any restrictions or conditions) to a former Endeavor employee in exchange for services performed. The compensation expense associated with the share grant is approximately \$98 and is reflected in operating expenses for the year ended December 31, 2008 in the consolidated financial statements, and was based upon the September 29, 2008 closing price per share of \$7.80.

As of December 31, 2008, the Company has not granted any stock awards under the 2007 Plan, other than as described above.

*Accounting for Warrants*

On December 21, 2005, the Registrant sold 15,000 units ( Units ) in the Offering at \$8.00 per Unit. On January 5, 2006, the Registrant sold an additional 1,161 Units pursuant to the underwriters' over-allotment option. Each Unit consisted of one share of the Company's common stock, and one redeemable common stock purchase warrant (the Endeavor Warrant ). The Endeavor Warrant entitled the holder to purchase from the Company one share of common stock at an exercise price of \$6.00 commencing the later of the completion of the Merger or December 15, 2006 and expiring on December 14, 2009. The Endeavor Warrant was redeemable by the Company, at a price of \$.01 per Endeavor Warrant upon 30 days' notice after the Endeavor Warrant became exercisable, only in the event that the last sale price of the common stock is at least \$11.50 per share for any 20 trading days within a 30 trading day period ending on the third day prior to the date on which notice of redemption is given. Such notice of redemption was given on February 6, 2008. There was no cash settlement option for the Endeavor Warrant.

In connection with this Offering, the Company issued an option to the representative of the Underwriter to purchase 350 Units at an exercise price of \$10.00 per Unit (the Underwriters Purchase Option ). The Underwriters Purchase Option was exercised in December, 2007 in a cashless conversion, resulting in the issuance of 204 shares of common stock and 204 Endeavor Warrants. Additionally, 200 Endeavor Warrants were exercised in December 2007 resulting in aggregate proceeds of \$1,200. As a result, as of December 31, 2007, there were 16,165 Endeavor Warrants outstanding, all with an exercise price of \$6.00 per share, expiring on December 14, 2009.

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On February 6, 2008, the Company called for redemption of all of its issued and outstanding Endeavor Warrants. Prior to the redemption date of March 7, 2008, 16,153 of the 16,165 Endeavor Warrants outstanding at December 31, 2007 were exercised, generating net proceeds to the Company of \$65,619. The remaining 12 Endeavor Warrants were redeemed by the Company at a price of \$0.01 per Endeavor Warrant, where a portion of the Endeavor Warrants were exercised on a cashless basis. The Company issued 13,521 shares of common stock in connection with the redemption of the Endeavor Warrants.

On December 19, 2008, the Company entered into the Ninth Amendment with SOF to extend the maturity date of the SOF Loan from January 18, 2009 to April 20, 2009 (see Note 10). In conjunction with this extension, the Company issued to SOF the SOF Warrant to purchase 1,000 shares of common stock for an exercise price of \$3.00 per share, which exercise price is subject to adjustment under certain circumstances. The SOF Warrant has a five year term and expires on December 19, 2013. The fair value of the SOF Warrant of \$1,021 was determined under the Black-Scholes option pricing model. The calculation was based on a contractual term of five years, interest rate of 1.35%, volatility of 59.5% and no dividends. The cost related to the SOF Warrant will be recognized as interest expense over the remaining term of the SOF Loan.

The Company considered the provisions of EITF 07-5, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, with respect to the SOF Warrant, and concluded that the SOF Warrant was not indexed to in the Company's common stock as a result of the price adjustment provisions. Accordingly, the SOF Warrant will be accounted for as a derivative instrument pursuant to SFAS No. 133 and anticipate a cumulative effect gain of \$214 recorded to retained earnings upon the adoption of EITF 07-05 on January 1, 2009.

*Stock Repurchase*

On May 23, 2008, the Company's Board of Directors authorized a common stock repurchase program that allows the Company to repurchase up to an aggregate of \$25,000 of the Company's outstanding common stock through open market and privately negotiated transactions based on prevailing market conditions and other factors. At December 31, 2008, the Company had repurchased 1,433 shares of the Company's common stock for \$10,001 at a weighted average price of \$6.98 per share, plus brokerage commissions of \$43, leaving \$14,999 remaining under the program. All of the shares repurchased have been recorded as treasury stock.

**NOTE 16 Commitments and Contingencies***Operating Leases*

The Company conducts retail operations under operating leases, which expire at various dates through 2020. The Company's primary manufacturing facilities and executive offices are currently being leased on a month to month basis. Future minimum rental payments (excluding real estate tax and maintenance costs) for retail locations and other leases that have initial or non-cancelable lease terms in excess of one year at December 31, 2008 are as follows:

|              | <b>Amount</b>     |
|--------------|-------------------|
| 2009         | \$ 55,343         |
| 2010         | 51,581            |
| 2011         | 48,885            |
| 2012         | 46,020            |
| 2013         | 43,886            |
| Thereafter   | 145,189           |
| <b>Total</b> | <b>\$ 390,904</b> |

Operating lease rent expense (including real estate taxes and maintenance costs) and leases on a month to month basis were approximately \$59,205, \$38,171 and \$30,154 for the years ended December 31, 2008, 2007 and 2006, respectively. The Company did not incur any contingent rent (Note 3) during the same period. Rent expense is included in Cost of Sales and Operating Expenses in the accompanying Consolidated Statements of Operations.

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### *Sales Tax*

The Company has been contacted by the California State Board of Equalization in regard to scheduling a Sales and Use Tax audit for the period January 1, 2002 through December 31, 2004. No provision has been made for any future assessment, if any, which might be determined by the State Board of Equalization at the outcome of the audit.

### *California Franchise Tax Board*

The Company has been contacted by the California Franchise Tax Board in regard to scheduling an audit related to California Enterprise Zone Tax Credits taken by the Company for the 2001 and 2002 income tax years. No provision has been made for any future assessment, if any, which might be determined by the California Franchise Tax Board at the outcome of the audit. However, the California Enterprise Zone Tax Credits have a full valuation allowance at December 31, 2008 and 2007 (Note 13).

### *Advertising*

At December 31, 2008, the Company had approximately \$2,439 in open advertising commitments, which primarily relate to print advertisements in various newspapers and magazines during the remainder of 2009.

### *U.S. Immigration and Customs Enforcement*

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

### *Employment Agreements*

At Closing, Dov Charney became the Company's Chief Executive Officer and President. None of the Company's other pre-Merger officers continued with the Company after the Acquisition. Dov Charney also entered into an employment agreement with the Company, effective at the Closing. Effective with the Closing, Dov Charney no longer receives a management fee as compensation. Concurrent with the Closing, Dov Charney entered into a three year employment agreement that provides an annual salary of \$750. He is also entitled to an annual performance bonus of 150% of base salary upon achievement of annual goals to be set by the compensation committee subsequent to the acquisition and a long-term performance bonus of 300% of base salary upon achievement of three-year goals to be set by the compensation committee. As of December 31, 2008, these annual goals have not been set by the compensation committee.

### *Unused Available Line of Credit*

At December 31, 2008, the Company has a revolving credit facility with a Bank (Note 10a) providing for borrowings of up to \$75,000, of which \$49,401 is outstanding under this line of credit and \$12,142 was available for future borrowings at December 31, 2008.

At December 31, 2008, the Company has a revolving credit facility with a bank (Note 10b) providing for borrowings of up to C\$4,000 (CAN \$), of which \$409 is outstanding under this line of credit and \$2,862 was available for future borrowings at December 31, 2008.

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### *Compensation of Directors*

The Company agreed to grant its non-employee directors annual stock grants equal to the number of shares of the Company's common stock, having an aggregate market value of \$75 at the time of grant (the Annual Grant), with grants being made at the Closing of the Merger and subject to the annual confirmation and ratification by the Board each year, on each anniversary of service thereafter. The Board determined in December 2008 that the Annual Grant to the non-employee directors that was scheduled for December 12, 2008, would be granted on January 12, 2009, and that beginning on December 12, 2009, each non-employee director on each such December 12th, would be automatically awarded the Annual Grant on each such date, without any further action by the Board.

### *Stock Awards to Employees*

Pursuant to the Amended Acquisition Agreement, up to 2,710 shares of common stock may be issued to employees subsequent to the filing of the Form S-8 filed in April 2008. On August 14, 2008, 1,851 shares of common stock were awarded to eligible manufacturing employees. As of December 31, 2008, the Company estimates there are an additional 859 shares of common stock that may be awarded to eligible employees.

## **NOTE 17 Workers Compensation Self-Insurance Reserves**

### *Self Insurance Reserves*

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

The workers' compensation liability is based on estimate of losses for claims incurred, but not paid at year end. Funding is made directly to the providers and/or claimants by the insurance company. To guarantee performance under the workers' compensation program, as of December 31, 2008 and 2007, the Company has issued standby letters of credit in the amount of \$7,190 and \$5,940, respectively, with two insurance companies being the beneficiaries. At December 31, 2008 and 2007, the Company recorded a reserve of \$7,433 and \$4,838, respectively, for potential losses on existing claims as such amounts are believed to be probable and reasonably estimable.

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**NOTE 18 Business Segment and Geographic Area Information**

*Segment Information*

The Company's management evaluates performance based on a number of factors; however, the primary measures of performance are the net sales and income or loss from operations of each segment, as these are the key performance indicators reviewed by management. Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income/expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, information technology, accounting and finance, executive compensation, and various other corporate level activity related expenses. Such unallocated expenses remain within corporate. In the fourth quarter of 2008, the Company implemented and recorded a full year impact from changes to its intercompany transfer pricing policy which will significantly reduce the overall effective tax rate on our international earnings. While the application of the updated intercompany transfer pricing policy did not change the Company's revenue or operating performance on a consolidated basis, it impacted the allocation of gross profit and operating profit amongst the U.S. Wholesale, Canada and International segments in 2008 when compared to prior years. Intercompany charges related to the transfer pricing implementation included in cost of sales of the Canadian and International segments were \$5,306 and \$15,750, respectively, for the year ended December 31, 2008 and resulted in a corresponding decrease in cost of sales in the U.S. wholesale segment of \$21,056. The accounting policies of all operating segments are the same as those described in the summary of significant accounting policies in Note 3.

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

U.S. Internet sales are recorded in the U.S. Wholesale segment. Canada internet sales are included in the Canada segment and overseas International internet sales are included in the International segment. As of December 31, 2008, U.S. Retail was comprised of 148 Company owned retail stores operating in the United States; the Canada segment was comprised of 37 retail stores; and the International segment was comprised of 75 retail stores. All of these retail stores sell the Company's apparel products directly to consumers.

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The following table represents key financial information of the Company's business segments:

|                                 | For the Year ended December 31, 2008 |                |           |               |              |
|---------------------------------|--------------------------------------|----------------|-----------|---------------|--------------|
|                                 | U.S.<br>Wholesale                    | U.S.<br>Retail | Canada    | International | Consolidated |
| Net sales to external customers | \$ 162,668                           | \$ 168,653     | \$ 67,280 | \$ 146,449    | \$ 545,050   |
| Gross profit                    | 46,894                               | 127,936        | 40,072    | 84,213        | 299,115      |
| Income from operations          | 21,020                               | 33,483         | 10,754    | 7,985         | 73,242       |
| Depreciation and amortization   | 7,141                                | 6,974          | 2,409     | 4,320         | 20,844       |
| Capital expenditures            | 18,326                               | 30,860         | 4,701     | 18,263        | 72,150       |
| Deferred rent expense           | 262                                  | 4,042          | 321       | 3,121         | 7,746        |

|                                 | For the Year ended December 31, 2007 |                |           |               |              |
|---------------------------------|--------------------------------------|----------------|-----------|---------------|--------------|
|                                 | U.S.<br>Wholesale                    | U.S.<br>Retail | Canada    | International | Consolidated |
| Net sales to external customers | \$ 144,478                           | \$ 115,615     | \$ 42,407 | \$ 84,544     | \$ 387,044   |
| Gross profit                    | 40,148                               | 88,833         | 27,141    | 59,351        | 215,473      |
| Income from operations          | 19,743                               | 24,756         | 1,522     | 14,795        | 60,816       |
| Depreciation and amortization   | 4,927                                | 4,395          | 1,983     | 2,001         | 13,306       |
| Capital expenditures            | 5,343                                | 9,329          | 1,984     | 7,139         | 23,795       |
| Deferred rent (benefit) expense | (155)                                | 1,507          | 156       | 539           | 2,047        |

|   | For the Year ended December 31, 2006 |                |           |               |              |
|---|--------------------------------------|----------------|-----------|---------------|--------------|
|   | U.S.<br>Wholesale                    | U.S.<br>Retail | Canada    | International | Consolidated |
| Net sales to external customers   | \$ 127,761                           | \$ 80,210      | \$ 30,570 | \$ 46,425     | \$ 284,966   |
| Gross profit  | 31,729                               | 62,968         | 19,236    | 31,703        | 145,636      |
| Income from operations  | 14,221                               | 11,510         | 3,540     | 4,719         | 33,990       |
| Depreciation and amortization   | 4,905                                | 3,709          | 1,421     | 869           | 10,904       |
| Capital expenditures  | 4,252                                | 8,624          | 1,659     | 2,355         | 16,890       |
| Deferred rent expense   | 2                                    | 1,641          | 323       | 128           | 2,094        |
| Reconciliation to Income (loss) before Income Taxes for the year ended December 31, |                                      |                |           |               |              |

|  | 2008      | 2007      | 2006      |
|--|-----------|-----------|-----------|
| Consolidated Income from operations of reportable segments | \$ 73,242 | \$ 60,816 | \$ 33,990 |
| Corporate expenses   | (37,178)  | (29,694)  | (23,418)  |
| Interest expense   | (13,921)  | (17,541)  | (11,812)  |
| Other income (expense)                                     | (155)     | 980       | 607       |
| Foreign currency gain (loss)                               | (621)     | 722       | 601       |
| Consolidated Income (Loss) Before Income Taxes             | \$ 21,367 | \$ 15,283 | \$ (32)   |

|                                       | 2008       | 2007       | 2006       |
|---------------------------------------|------------|------------|------------|
| Net sales by location of customer     |            |            |            |
| United States                         | \$ 331,322 | \$ 260,093 | \$ 207,971 |
| Canada                                | 67,280     | 42,407     | 30,570     |
| Europe (excluding the United Kingdom) | 74,297     | 45,100     | 23,080     |
| United Kingdom                        | 35,653     | 17,647     | 10,031     |
| Korea                                 | 10,453     | 9,186      | 5,048      |
| Japan                                 | 14,909     | 9,840      | 6,499      |
| Other foreign countries               | 11,136     | 2,771      | 1,767      |

|                              |            |            |            |
|------------------------------|------------|------------|------------|
| Total Consolidated Net Sales | \$ 545,050 | \$ 387,044 | \$ 284,966 |
|------------------------------|------------|------------|------------|



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Long-lived assets Property and equipment, net, as of December 31,

|   | <b>2008</b>    | <b>2007</b>    |
|---|----------------|----------------|
| United States                             | \$ 79,286      | \$ 43,984      |
| Canada                                    | 7,251          | 6,623          |
| Europe (excluding the United Kingdom)     | 12,682         | 7,273          |
| United Kingdom                            | 6,439          | 4,594          |
| Korea                                     | 703            | 512            |
| Japan                                     | 3,278          | 1,636          |
| Other foreign countries                   | 2,769          | 246            |
| <br>Consolidated Long-lived Assets        | <br>\$ 112,408 | <br>\$ 64,868  |
| <br><b>Identifiable assets by segment</b> |                |                |
| US Wholesale                              | \$ 178,060     | \$ 125,422     |
| US Retail                                 | 98,947         | 59,961         |
| Canada                                    | 17,112         | 16,506         |
| International                             | 38,886         | 31,461         |
| <br>Total                                 | <br>\$ 333,005 | <br>\$ 233,350 |

Foreign subsidiaries accounted for the following percentages of assets and total liabilities as of December 31,

|                   | <b>2008</b> | <b>2007</b> |
|-------------------|-------------|-------------|
| Total assets      | 16.8%       | 20.6%       |
| Total liabilities | 14.5%       | 17.4%       |

|  | <b>Twelve Months Ended December 31,</b> |                       |                      |
|--|---|-----------------------|----------------------|
|  | <b>2008</b>                             | <b>2007</b>           | <b>2006</b>          |
| <b>Net sales by class of customer:</b> |   |                       |                      |
| <b>U.S. Wholesale</b>                  |   |                       |                      |
| Wholesale                              | \$ 137,185                              | \$ 125,609            | \$ 118,534           |
| Online Consumer                        | 25,483                                  | 18,869                | 9,227                |
| <b>Total</b>                           | <b>\$ 162,668</b>                       | <b>\$ 144,478</b>     | <b>\$ 127,761</b>    |
| <br><b>U.S. Retail</b>                 | <br><b>\$ 168,653</b>                   | <br><b>\$ 115,615</b> | <br><b>\$ 80,210</b> |
| <br><b>Canada</b>                      |   |                       |                      |
| Wholesale                              | \$ 12,708                               | \$ 11,335             | \$ 13,097            |
| Retail                                 | 52,872                                  | 30,068                | 17,078               |
| Online Consumer                        | 1,700                                   | 1,004                 | 395                  |
| <b>Total</b>                           | <b>\$ 67,280</b>                        | <b>\$ 42,407</b>      | <b>\$ 30,570</b>     |
| <br><b>International</b>               |   |                       |                      |
| Wholesale                              | \$ 14,510                               | \$ 12,631             | \$ 6,153             |
| Retail                                 | 119,749                                 | 65,297                | 37,425               |

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|                     |            |            |            |
|---------------------|------------|------------|------------|
| Online Consumer     | 12,190     | 6,616      | 2,847      |
| Total               | \$ 146,449 | \$ 84,544  | \$ 46,425  |
| <b>Consolidated</b> |            |            |            |
| Wholesale           | \$ 164,403 | \$ 149,575 | \$ 137,784 |
| Retail              | 341,274    | 210,980    | 134,713    |
| Online Consumer     | 39,373     | 26,489     | 12,469     |
| Total               | \$ 545,050 | \$ 387,044 | \$ 284,966 |

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**Table of Contents****NOTE 19 Litigation**

The Company is subject to various claims and contingencies in the ordinary course of its business, including those related to litigation, business transactions, employee-related matters and taxes, and others. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the Company will record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. While there can be no assurances, the Company does not expect that any of its pending legal proceedings will have a material financial impact on the Company's results.

On or about September 19, 2005, Ms. Mary Nelson, an independent contractor in the sales department at American Apparel, commenced a suit in a case captioned as *Mary Nelson v. American Apparel, Inc., et al.*, Case Number BC333028, filed in Superior Court of the State of California for the County of Los Angeles, Central District, wherein she alleges she was wrongfully terminated, was subjected to harassment and discrimination based upon her gender and other claims related to her tenure at American Apparel. The Company denies all of Ms. Nelson's allegations of wrongdoing. Ms. Nelson is seeking unspecified monetary damages and costs. The trial has been stayed, and the Court of Appeal of the State of California has reversed the Superior Court's denial of the Company's motion to compel arbitration pursuant to an agreement among the parties. The Company anticipates that arbitration will now occur. The insurance carrier for the Company's directors' and officers' insurance policy has asserted that it is not obligated to provide coverage for this proceeding. American Apparel intends to aggressively defend any allegations of wrongdoing.

On February 7, 2006, Sylvia Hsu, a former employee of American Apparel, filed a Charge of Discrimination with the Los Angeles District Office of the Equal Employment Opportunity Commission (EEOC) (*Hsu v. American Apparel: Charge No. 480- 2006-00418*), alleging that she was subjected to sexual harassment by a co-worker and constructively discharged as a result of the sexual harassment and hostile working environment. The EEOC's investigation of this charge is ongoing. On March 9, 2007, the EEOC expanded the scope of its investigation to other employees of American Apparel who may have been sexually harassed. In February 2008, the EEOC requested to speak with certain managers, supervisors and other employees of the Company in connection with its investigation. Given the broad scope of the EEOC's investigation, it is impossible to predict with any degree of accuracy how this matter will develop, how it will be resolved, what remedies or relief, if any, will be sought or what the impact might be on American Apparel. American Apparel intends to aggressively defend any allegations of wrongdoing.

On March 31, 2008, Woody Allen filed suit against the Company, in the United States District Court for the Southern District of New York, for the alleged unauthorized use of his image. Through his suit, Mr. Allen is seeking monetary damages in an amount he believes to be in excess of \$10 million, disgorgement of any profits the Company may have realized as a result of its alleged unauthorized use of Mr. Allen's image, exemplary damages, and attorneys' fees and costs. The Company believes that Mr. Allen's claims are defensible and is vigorously litigating its position. In addition, the Company's insurance company has agreed, without any reservation of rights, to cover a portion of defense costs and any adverse judgment which may be entered against the Company, up to the policy limits of \$11 million, except for any exemplary damages which may be awarded.

The Company is currently engaged in other employment-related claims and other matters incidental to the Company's business. We believe that all such claims against the Company are without merit or not material, and we intend to vigorously dispute the validity of the plaintiffs' claims. While the ultimate resolution of such claims cannot be determined, based on information at this time, we believe the amount, and ultimate liability, if any, with respect to these actions will not materially affect our business, financial position, results of operations, or cash flows. We cannot assure you, however, that such actions will not have a material adverse effect on our consolidated results of operations, financial position or cash flow.

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### **NOTE 20 Subsequent Events**

On January 12, 2009, the Company issued the second annual grant to each non-employee director approximately 35 shares of common stock, based upon the closing price per share of \$2.13.

On February 10, 2009, Dov Charney, loaned the Company \$4,000 in exchange for a promissory note (the Promissory Note). The Promissory Note matures in January 2013 and provides for interest at an annual rate of 6%, payable in kind. The Promissory Note contains customary events of default under which the Promissory Note may be accelerated, and the principal amount and accrued interest on the Promissory Note may be prepaid, in whole or in part, at any time without penalty.

On March 13, 2009, the Company entered into the Lion Credit Agreement. Pursuant to the Lion Credit Agreement, the Initial Lender made term loans to the Company in an aggregate principal amount equal to \$80,000, of which \$5,000 of such loans constitute a fee paid by the Company to Lion Capital LLP in connection with the Lion Credit Agreement. The term loans under the Lion Credit Agreement mature on December 31, 2013 and bear interest at a rate of 15% per annum, payable quarterly in arrears. At the Company's option, accrued interest may be paid (i) entirely in cash, (ii) paid half in cash and half in kind, or (iii) entirely in kind. The Company's obligations under the Lion Credit Agreement are secured by a second lien on substantially all of the assets of the Company. The Lion Credit Agreement contains customary representations and warranties, events of default, affirmative covenants and negative covenants (which impose restrictions and limitations on, among other things, dividends, investments, asset sales, capital expenditures and the ability of the Company to incur additional debt and liens) and a total leverage ratio financial maintenance covenant. The Company is permitted to prepay the loans in whole or in part at any time at its option, with no prepayment penalty.

A portion of the proceeds of the loans made under the Lion Credit Agreement was used by the Company to repay in full all outstanding amounts due and owing under the SOF Credit Agreement. The remaining proceeds were used to reduce the outstanding revolver balance under the BofA Credit Agreement, to repay \$3,250 of loans owed by the Company to Dov Charney, and to pay fees and expenses related to the transaction.

In connection with the loans under the Lion Credit Agreement, the Company issued to Lion a seven-year warrant, which is exercisable at any time during its term, to purchase an aggregate of 16,000 shares of the Company's common stock at an exercise price of \$2.00 per share. The Lion warrants will be recorded as a debt discount and a credit to stockholders' equity at its relative fair value of approximately \$15,000. The debt net of discount totalling approximately \$60,000, will be accreted to the \$80,000 par value of the loan using the effective interest method over the term of the Lion Credit Agreement. The warrant may be exercised by Lion by paying the exercise price in cash, pursuant to cashless exercise of the warrant or by a combination of the two methods. The Lion Warrant contains certain anti-dilution protections in favor of Lion providing for proportional adjustment of the warrant price and, under certain circumstances, the number of shares of the Company's common stock issuable upon exercise of the Lion warrant, in connection with, among other things, stock dividends, subdivisions and combinations and the issuance of additional equity securities of the Company at less than fair market value.

**Table of Contents****Schedule II****American Apparel, Inc. and Subsidiaries****Valuation and Qualifying Accounts**

| Description   | Balance at<br>Beginning<br>of Year | Charged to<br>costs and<br>Expenses | Deductions<br>(recoveries) | Other                | Balance<br>at End<br>of Year |
|---|------------------------------------|-------------------------------------|----------------------------|----------------------|------------------------------|
| <b>Allowance for trade accounts receivable:</b>                       |                                    |                                     |                            |                      |                              |
| For the year ended December 31, 2008                                  | 1,876                              | 598                                 |                            | (1,033) <sup>1</sup> | 1,441                        |
| For the year ended December 31, 2007                                  | 2,189                              |                                     | (313)                      |                      | 1,876                        |
| For the year ended December 31, 2006                                  | 1,112                              | 1,077                               |                            |                      | 2,189                        |
| <b>Allowance for inventory shrinkage and slow moving inventories:</b> |                                    |                                     |                            |                      |                              |
| For the year ended December 31, 2008                                  | 5,349                              |                                     | (1,731)                    |                      | 3,618                        |
| For the year ended December 31, 2007                                  | 4,812                              | 537                                 |                            |                      | 5,349                        |
| For the year ended December 31, 2006                                  | 800                                | 4,012                               |                            |                      | 4,812                        |

<sup>1</sup> Foreign exchange rate fluctuation

**Table of Contents****Supplementary Financial Information**

The following quarterly data are derived from our Consolidated Statements of Operations.

**QUARTERLY INFORMATION (unaudited)**

(\$ in thousands except per share amounts)

|   | Quarter Ended<br>December 31, 2008    | Quarter Ended<br>September 30, 2008    | Quarter Ended<br>June 30, 2008    | Quarter Ended<br>March 31, 2008       | Year Ended<br>December 31, 2008    |
|---|---------------------------------------|--|-----------------------------------|---------------------------------------|------------------------------------|
| <b>Fiscal 2008</b>  |                                       |  |                                   |                                       |                                    |
| Net sales   | \$ 145,644                            | \$ 154,801                             | \$ 132,971                        | \$ 111,634                            | \$ 545,050                         |
| Gross profit  | \$ 80,674                             | \$ 77,622                              | \$ 79,070                         | \$ 61,749                             | \$ 299,115                         |
| Net income  | \$ 3,884                              | \$ 2,333                               | \$ 6,791                          | \$ 1,104                              | \$ 14,112                          |
| Earnings per share-basic  | \$ .05                                | \$ .03                                 | \$ .10                            | \$ .02                                | \$ .20                             |
| Earnings per share-diluted  | \$ .05                                | \$ .03                                 | \$ .10                            | \$ .02                                | \$ .20                             |
|   | Quarter Ended<br>December 31,<br>2007 | Quarter Ended<br>September 30,<br>2007 | Quarter<br>Ended<br>June 30, 2007 | Quarter<br>Ended<br>March 31,<br>2007 | Year Ended<br>December 31,<br>2007 |
| <b>Fiscal 2007</b>  |                                       |  |                                   |                                       |                                    |
| Net sales   | \$ 111,191                            | \$ 106,620                             | \$ 95,730                         | \$ 73,503                             | \$ 387,044                         |
| Gross profit  | \$ 60,527                             | \$ 58,889                              | \$ 54,073                         | \$ 41,984                             | \$ 215,473                         |
| Net income  | \$ 2,995                              | \$ 6,007                               | \$ 4,793                          | \$ 1,683                              | \$ 15,478                          |
| Earnings per share-basic  | \$ .06                                | \$ .12                                 | \$ .10                            | \$ .03                                | \$ .32                             |
| Earnings per share-diluted  | \$ .06                                | \$ .12                                 | \$ .10                            | \$ .03                                | \$ .31                             |
| <b>Pro forma Computation Related to<br/>Conversion to C Corporation for<br/>income tax purposes</b> |                                       |  |                                   |                                       |                                    |
| Historical income (loss) before taxes   | \$ (2,682)                            | \$ 8,125                               | \$ 7,496                          | \$ 2,344                              | \$ 15,283                          |
| Pro forma provision (benefit) for<br>income taxes   | \$ (1,022)                            | \$ 3,097                               | \$ 2,857                          | \$ 894                                | \$ 5,826                           |
| Pro forma income (loss)   | \$ (1,660)                            | \$ 5,028                               | \$ 4,639                          | \$ 1,450                              | \$ 9,457                           |
| Earnings per share-basic  | \$ (.03)                              | \$ .10                                 | \$ .10                            | \$ .03                                | \$ .19                             |
| Earnings per share-diluted  | \$ (.03)                              | \$ .10                                 | \$ .10                            | \$ .03                                | \$ .19                             |

**Seasonality**

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

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosures**

None.

**Item 9A. Controls and Procedures****(a) Disclosure Controls and Procedures**

Under the supervision and participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and



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procedures as such term is defined under Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ).

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

***(b) Management's Report on Internal Control Over Financial Reporting***

Management is responsible for establishing and maintaining adequate Internal Control over Financial Reporting ( ICFR ). We maintain ICFR designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, ICFR may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Therefore, ICFR determined to be effective provides only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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

Management evaluated our ICFR as of December 31, 2008. In making this assessment, management used the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Marcum & Kliegman LLP, our independent registered public accounting firm, has issued an attestation report on our internal control over financial reporting as of December 31, 2008. This report is included below. As a result of this assessment and based on the criteria in the COSO framework, management has concluded that, as of December 31, 2008, our ICFR was not effective due to the existence of the following material weaknesses:

- 1) ***Inadequate Expertise in the application of U.S. Generally Accepted Accounting Principles:*** At its foreign offices, the Company did not have a sufficient number of adequately trained accounting personnel with appropriate expertise in United States generally accepted accounting principles (US GAAP). Also, the Company lacked sufficient US GAAP expertise to ensure that certain complex material and non-routine transactions are properly reflected in its consolidated financial statements. Consequently, the Company may not anticipate and identify accounting issues, or other risks critical to financial reporting, that could materially impact the consolidated financial statements.
- 2) ***Inadequate Reviews:*** In certain instances, the Company's personnel, at both U.S. and foreign operations, did not perform adequate independent review of reconciliations and other processes.
- 3) ***Inadequate Financial Information Systems:*** The Company's world-wide financial information systems were not integrated and contained many manual processes that may prevent the Company from meeting regulatory filing requirements on a timely and accurate basis. The Company has also identified information technology control weaknesses in the areas of information security, end-user computing, systems program development and change controls.



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***(c) Remediation Activities***

As previously reported, there were five material weaknesses in our internal control over financial reporting as of December 31, 2007. During Fiscal 2008 the Company remediated two material weaknesses and has taken substantial measures to remediate the remaining material weaknesses, described as follows:

***Assessment of ICFR:*** The Company conducted an assessment of the effectiveness of the Company's ICFR. The Company considers this material weakness remediated.

***Ineffective Entity-Level Controls:*** The Company hired additional staff with appropriate education, knowledge of US GAAP, SEC reporting experience and other professional qualifications to improve the quality of its financial reporting. The company instituted a COSO based evaluation over ICFR. Besides the additional Company staff, the Company retained third party technical experts to improve disclosure and ICFR, as well as to improve the timeliness and accuracy of its financial reporting. The Company considers this material weakness remediated.

***Inadequate Expertise in the application of U.S. Generally Accepted Accounting Principles:*** The Company hired additional credentialed professional staff with greater knowledge of US GAAP in both its domestic operations, and in positions of oversight and management of its foreign operations. In addition, the Company engaged appropriate professional services firms in order to improve accuracy of its financial reporting under US GAAP in key foreign reporting locations. The Company's management has sufficient knowledge to review the work of internal and external subject matter experts, and reviews all workpapers from its foreign operations to ensure compliance with US GAAP.

a. Accounting for Income Taxes: The Company has engaged a third party service provider and implemented training and review procedures over its income tax process to provide adequate knowledge and ensure proper review of the provision for income taxes, including deferred taxes, in its consolidated financial statements. The Company considers this material weakness remediated.

b. Financial Reporting by Foreign Subsidiaries: The Company has hired additional credentialed professional staff with greater knowledge of US GAAP in both its domestic operations, and in the oversight and management of its foreign operations. The Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.

c. Other Accounting Matters: The Company has hired or retained sufficient competent personnel with appropriate US GAAP and SEC reporting experience to remediate this issue. The Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.

***Inadequate Reviews:*** The Company instituted and formalized multiple levels of review and internal controls at foreign and U.S. Operations for reconciliations and other processes which are deemed key to the financial statements. The Company's review processes have been implemented and the Company has made substantial progress and is continuing its efforts toward remediation of this material weakness.

***Inadequate Financial Information Systems:*** The Company has identified systems and applications that impact financial reporting and is taking actions to safeguard financial reporting information assets as well as to help ensure the integrity of financial information used in the preparation of financial reports. The Company has adopted an Information Technology framework, is documenting key information technology controls and is addressing control weaknesses that could potentially impact financial reporting. In addition, the Company has implemented a number of new policies, procedures, and controls in the areas of information security, change management, operations and end-user computing. The Company is in the process of implementing an integrated ERP system for its U.S. operations. It has reviewed its personnel and information systems for foreign operations and has added professional staff resources for review and control over financial reporting by the foreign

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operations. The Company has placed substantial mitigating controls around its heretofore manual consolidation process, and is in the process of implementing a high-level replacement system for those manual processes to further improve controls and to reduce the time required to produce its financial statements and regulatory filings. In addition, the Company has identified and implemented additional review controls over financial reporting to validate information derived from its information systems and ultimately reported in our financial statements. As the Company continues to upgrade various systems, controls and procedures, it is continuing to make substantial progress and is continuing its efforts toward remediation of this material weakness.

***(d) Changes in ICFR***

During the 2008 and during the quarter ended December 31, 2008, the Company's management initiated the steps outlined above under Remediation Activities to improve the quality of its ICFR.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

To the Audit Committee of the  
Board of Directors and Stockholders of  
American Apparel, Inc.

We have audited American Apparel, Inc.'s (the Company) internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weaknesses have been identified and included in Management's Report on Internal Control Over Financial Reporting :

1) ***Inadequate Expertise in the application of U.S. Generally Accepted Accounting Principles:*** At its foreign offices, the Company did not have a sufficient number of adequately trained accounting personnel with appropriate expertise in United States generally accepted accounting principles (US GAAP). Also, the Company lacked sufficient US GAAP expertise to ensure that certain complex material and non-routine transactions were properly reflected in its consolidated financial statements. Consequently, the Company may not anticipate and identify accounting issues, or other risks critical to financial reporting, that could materially impact the consolidated financial statements.

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2) ***Inadequate Reviews:*** In certain instances, the Company's personnel, at both U.S. and foreign operations, did not perform adequate independent review of reconciliations and other processes.

3) ***Inadequate Financial Information Systems:*** The Company's world-wide financial information systems were not integrated and contained many manual processes that may prevent the Company from meeting regulatory filing requirements on a timely and accurate basis. The Company has also identified information technology control weaknesses in the areas of information security, end-user computing, systems program development and change controls.

These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the December 31, 2008 consolidated financial statements and financial statement schedule, and this report does not affect our report dated March 16, 2009.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, American Apparel, Inc. has not maintained effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2008 and 2007 and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows and related financial statement schedule for the years ended December 31, 2008, 2007 and 2006 of the Company and our report dated March 16, 2009 expressed an unqualified opinion on those financial statements and financial statement schedule.

Marcum & Kliegman LLP

New York, NY

March 16, 2009

**Item 9B. Other Information**

Not applicable

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**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this item is omitted herein as the required information will be included in the 2009 Proxy Statement.

The Company has adopted a Code of Ethics that applies to all employees including our principal executive officer, principal financial officer, controller and persons performing similar functions. The Code of Ethics and any amendments thereto are available for inspection at the Company's principal offices. Our Code of Ethics is posted on the Company website, *www.americanapparel.net*.

**Item 11. Executive Compensation**

The information required by this item is omitted herein as the required information will be included in the 2009 Proxy Statement.

On March 11, 2009, Joyce Crucillo, American Apparel (USA), LLC (as successor to Old American Apparel) and the Company entered into an amendment to her employment agreement to, effective as of February 17, 2009, (i) reflect the change in her title to Chief Litigation Counsel, and (ii) provide that if Ms. Crucillo is laid off, terminated (irrespective of whether such termination is with or without cause) or otherwise dismissed by the Company, then the Company will pay to her, as a severance payment, six months of her then current total annual compensation, which includes her annual base salary and annual guaranteed bonuses (regardless of whether any portion thereof has accrued or vested), plus continued health insurance benefits identical to what she was receiving at the time of separation for a period of six months after she leaves the Company. In addition, the amendment provided for the assignment by American Apparel (USA), LLC of its rights, duties and obligations under the employment agreement as employer to the Company, such that Ms. Crucillo is now employed directly by the Company instead of its subsidiary American Apparel (USA), LLC.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item is omitted herein as the required information will be included in the 2009 Proxy Statement.

**Item 13. Certain Relationships and Related Transactions and Director Independence**

The information required by this item is omitted herein as the required information will be included in the 2009 Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

The information required by this item is omitted herein as the required information will be included in the 2009 Proxy Statement.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

(a) Documents filed as part of this Annual Report on Form 10-K:

1. Financial Statements: See Index to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K.
2. Financial Statement Schedule: The following consolidated financial statement schedule of American Apparel, Inc. and its subsidiaries is included in Part II, Item 8:

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|---|-------------|
| Schedule II - Valuation and Qualifying Accounts | 99          |

Schedules other than those listed above are omitted because of an absence of the conditions under which they are required or because the required information is shown in the consolidated financial statements and/or notes thereto.

(b) Exhibits: The exhibits listed in the accompanying index to exhibits are filed or incorporated by reference as part of this Annual Report on Form 10-K.

*In reviewing the agreements included as exhibits to this Annual Report on Form 10-K, please remember they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about the Company or the other parties to the agreements. The agreements contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other parties to the applicable agreement and:*

*should not in all instances be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate;*

*have been qualified by disclosures that were made to the other party in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;*

*may apply standards of materiality in a way that is different from what may be viewed as material to you or other investors; and*

*were made only as of the date of the applicable agreement or such other date or dates as may be specified in the agreement and are subject to more recent developments.*

*Accordingly, these representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about the Company may be found elsewhere in this Annual Report on Form 10-K and in the Company's other public filings, which are available without charge through the SEC's website at <http://www.sec.gov>.*

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 2.1                | Acquisition Agreement, dated as of December 18, 2006 and amended and restated on November 7, 2007, by and among the Registrant, AAI Acquisition LLC, American Apparel, Inc., a California corporation, American Apparel, LLC, each of American Apparel Canada Wholesale Inc. and American Apparel Canada Retail Inc. (together the "CI companies"), Dov Charney, Sam Lim, and the stockholders of each of the CI companies (included as Annex A of the Definitive Proxy Statement (File No. 001-32697) filed November 28, 2007 and incorporated by reference herein) |
| 3.1                | Amended and Restated Certificate of Incorporation of the Registrant (included as Exhibit 3.1 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 3.2                | Bylaws of the Registrant (included as Exhibit 3.1 of the Current Report on Form 8-K (File No. 001-32697) filed November 9, 2007 and incorporated by reference herein)  |
| 3.3                | Certificate of Amendment to Certificate of Formation of American Apparel (USA), LLC (included as Exhibit 3.3 to Form 10-K (File No 001-32697) filed March 17, 2008 and incorporated by reference herein)   |
| 4.1                | Specimen Common Stock Certificate (included as Exhibit 4.2 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 4.2                | Registration Rights Agreement, dated December 12, 2007, by and among the Registrant and the stockholders listed on the signature page therein (included as Annex H of the Definitive Proxy Statement (File No. 001-32697) filed November 28, 2007 and incorporated by reference herein)  |
| 4.3                | Voting Agreement, dated December 12, 2007, between the Registrant and the Stockholders listed on the signature page therein (included as Annex E of the Definitive Proxy Statement (File No. 001-32697), filed November 28, 2007 and incorporated by reference herein)   |
| 4.4                | Lock-Up Agreement, dated December 12, 2007, between the Registrant and Dov Charney (included as Annex D of the Definitive Proxy Statement (File No. 001-32697), filed November 28, 2007 and incorporated by reference herein)  |
| 4.5                | Letter Agreement Re: Extension of Lock-Up Agreement, dated March 13, 2009, among Dov Charney, Lion Capital (Guernsey) II Limited and the Registrant (included as Exhibit 10.5 of the Current Report on Form 8-K (File No 001-32697) filed March 16, 2009 and incorporated by reference herein)   |
| 4.6                | Warrants to Purchase Shares of Common Stock of the Registrant, dated December 19, 2008, issued to SOF Investments, L.P. Private IV (included as Exhibit 10.2 of the Current Report on Form 8-K (File No. 001-32697) filed December 19, 2008 and incorporated by reference herein)  |
| 4.7                | Warrants to Purchase Shares of Common Stock of the Registrant, dated March 13, 2009, issued to Lion Capital (Guernsey) II Limited (included as Exhibit 10.3 of the Current Report on Form 8-K (File No 001-32697) filed March 13, 2009 and incorporated by reference herein)   |
| 4.8                | Investment Agreement, dated March 13, 2009, between the Registrant and Lion Capital (Guernsey) II Limited (included as Exhibit 10.2 of the Current Report on Form 8-K (File No 001-32697) filed March 16, 2009 and incorporated by reference herein)   |
| 4.9                | Investment Voting Agreement, dated March 13, 2009, between the Registrant and Lion Capital (Guernsey) II Limited (included as Exhibit 10.4 of the Current Report on Form 8-K (File No 001-32697) filed March 16, 2009 and incorporated by reference herein)  |
| 10.1+              | Employment Agreement, dated December 12, 2007, between the Registrant, American Apparel, LLC and Dov Charney (included as Annex J of the Definitive Proxy Statement (File No. 001-32697) filed November 28, 2007 and incorporated by reference herein)   |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.2               | Escrow Agreement, dated July 2, 2007, by and among the Registrant, Dov Charney and Continental Stock Transfer & Trust Company (included as Annex G of the Definitive Proxy Statement (File No. 001-32697) filed November 28, 2007 and incorporated by reference herein)  |
| 10.3+              | Registrant's 2007 Performance Incentive Equity Plan (included as Annex C of the Definitive Proxy Statement (File No. 001-32697) filed November 28, 2007 and incorporated by reference herein)  |
| 10.4+              | First Amendment to the 2007 Performance Equity Plan (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed October 30, 2008 and incorporated by reference herein)  |
| 10.5               | Credit Agreement, dated as of July 2, 2007 (the BofA Credit Agreement), among American Apparel (USA), LLC (AAUSA and f/k/a AAI Acquisition LLC (successor by merger to American Apparel, Inc.)), the other borrowers thereto, the facility guarantors party thereto, Bank of America, N.A. (successor by merger to LaSalle Bank National Association) as issuing bank, the other lenders thereto, Bank of America, N.A. (successor by merger of LaSalle Business Credit, LLC, as agent for LaSalle Bank Midwest National Association, acting through its division, LaSalle Retail Finance) as administrative agent and collateral agent, and Wells Fargo Retail, Finance, LLC as the collateral monitoring agent. (included as Exhibit 10.8 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein) |
| 10.6               | First Amendment to Credit Agreement, dated October 11, 2007, amending the BofA Credit Agreement (included as Exhibit 10.9 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.7               | Second Amendment and Waiver to Credit Agreement, dated November 26, 2007, amending the BofA Credit Agreement (included as Exhibit 10.10 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.8               | Third Amendment to Credit Agreement, dated December 12, 2007, amending the BofA Credit Agreement (included as Exhibit 10.7 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.9               | Waiver to Credit Agreement, dated February 29, 2008, waiving certain provisions in BofA Credit Agreement (included as Exhibit 10.8 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.10              | Waiver to Credit Agreement, dated May 16, 2008, waiving certain provisions in BofA Credit Agreement (included as Exhibit 10.28 of Quarterly Report on Form 10-Q (File No. 001-32697) filed May 16, 2009 and incorporated by reference herein)  |
| 10.11              | Waiver to Credit Agreement, dated as of June 5, 2008, amending the BofA Credit Agreement (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed June 9, 2008 and incorporated by reference herein)   |
| 10.12              | Fourth Amendment to Credit Agreement, dated June 20, 2008, amending the BofA Credit Agreement (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed June 24, 2008 and incorporated by reference herein)   |
| 10.13              | Fifth Amendment to Credit Agreement, dated as of December 19, 2008, amending the BofA Credit Agreement (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed December 19, 2008 and incorporated by reference herein)  |
| 10.14              | Sixth Amendment to Credit Agreement, dated as of March 13, 2009, amending the BofA Credit Agreement (included as Exhibit 10.7 of Current Report on Form 8-K (File No. 001-32697) filed March 16, 2009 and incorporated by reference herein)  |



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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.15              | Credit Agreement, dated as of January 18, 2007 (the SOF Agreement ), among AAUSA, the Facility Guarantors, and SOF Investments, L.P. Private IV ( SOF ) (included as Exhibit 10.11 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 10.16              | Amendment No. 1 and Waiver to Credit Agreement of AAUSA, dated as of July 2, 2007, amending the SOF Agreement, among AAUSA, the Facility Guarantors, and SOF (included as Exhibit 10.12 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.17              | Amendment No. 2 and Waiver to Credit Agreement of AAUSA, dated as of November 9, 2007, amending the SOF Agreement, among AAI, the Facility Guarantors, and SOF (included as Exhibit 10.13 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.18              | Amendment No. 3 and Waiver to Credit Agreement of AAUSA, dated as of November 28, 2007, amending the SOF Agreement, among AAI, the Facility Guarantors, and SOF (included as Exhibit 10.14 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 10.19              | Amendment No. 4 and Waiver to Credit Agreement of AAUSA, dated as of December 12, 2007, amending the SOF Agreement, among AAI, the Facility Guarantors, and SOF (included as Exhibit 10.13 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.20              | Amendment No. 5 and Waiver to Credit Agreement of AAUSA, dated as of February 29, 2008, amending the SOF Agreement, among American Apparel (USA), LLC, the Facility Guarantors, and SOF (included as Exhibit 10.14 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.21              | Amendment No. 6 and Waiver to Credit Agreement of AAUSA, dated as of May 16, 2008, amending the SOF Agreement, among American Apparel (USA), LLC, the Facility Guarantors, and SOF (included as Exhibit 10.27 of Quarterly Report on Form 10-Q (File No. 001-32697) filed May 16, 2009 and incorporated by reference herein)   |
| 10.22              | Amendment No. 7 to Credit Agreement of AAUSA, dated as of June 20, 2008, amending the SOF Agreement, among American Apparel (USA), LLC, the Facility Guarantors, and SOF (included as Exhibit 10.2 of Current Report on Form 8-K (File No. 001-32697) filed June 24, 2008 and incorporated by reference herein)  |
| 10.23*             | Amendment No. 8 to Credit Agreement of AAUSA, dated as of November 7, 2008, amending the SOF Agreement, among American Apparel (USA), LLC, the Facility Guarantors, and SOF  |
| 10.24              | Amendment No. 9 to Credit Agreement of AAUSA, dated as of December 19, 2008, amending the SOF Agreement, among American Apparel (USA), LLC, the Facility Guarantors, and SOF (included as Exhibit 10.3 of Current Report on Form 8-K (File No. 001-32697) filed December 19, 2008 and incorporated by reference herein)  |
| 10.25              | Lease, dated June 9, 2004, by and between Titan Real Estate Investment Group, Inc., and Textile Unlimited Corp., E&J Textile Group, Inc., and Johnester Knitting, Inc. (jointly and severally) (included as Exhibit 10.15 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.26              | Assignment of Lessee s Interest in Lease and Assumption Agreement, dated as of June 2, 2005, by and between Textile Unlimited Corp., E&J Textile Group, Inc., and Johnester Knitting, Inc. (jointly and severally) and American Apparel Dyeing and Finishing, Inc. (included as Exhibit 10.16 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein) |

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| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 10.27              | Lease, dated December 13, 2005, by and between American Central Plaza and AAI (included as Exhibit 10.17 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.28              | Lease Amendment, effective as of November 15, 2006, by and between American Central Plaza and AAI (included as Exhibit 10.18 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.29              | Lease Amendment, effective as of March 22, 2007, by and between American Central Plaza and AAI (included as Exhibit 10.19 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 10.30              | Credit facilities agreement, dated December 3, 2007, among The Toronto-Dominion Bank and American Apparel Canada Wholesale Inc./American Apparel Canada Grossiste Inc. and Les Boutiques American Apparel Canada Inc./American Apparel Canada Retail Inc. (included as Exhibit 10.20 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein) |
| 10.31              | Lease, dated as of January 1, 2004, by and between Alameda Produce Market, Inc. and AAI (included as Exhibit 10.21 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)   |
| 10.32              | Lease, dated as of May 12, 2004, by and between Alameda Produce Market, Inc. and AAI (included as Exhibit 10.22 of the Current Report on Form 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 10.33+             | Employment Agreement, dated as of October 26, 2006, between the Registrant and Joyce E. Crucillo (included as Exhibit 10.23 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.34*+            | First Amendment to Employment Agreement, dated as of March 11, 2009, among the Registrant, AAUSA and Joyce E. Crucillo  |
| 10.35              | Asset Purchase Agreement, dated as of December 1, 2007, by and between PNS Apparel, Inc., Blue Man Group, Inc., Allen S. Yi and American Apparel, Inc. (included as Exhibit 10.24 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.36              | Promissory Note, dated December 11, 2007, between American Apparel Canada Wholesale Inc. and Dov Charney (included as Exhibit 10.26 of Amendment No. 1 to the Annual Report on Form 10-K/A (File No. 001-32697) filed March 28, 2008 and incorporated by reference herein)  |
| 10.37+             | Executive Services Agreement, dated May 12, 2008, by and between Tatum, LLC and the Registrant (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed May 22, 2008 and incorporated by reference herein)  |
| 10.38+             | Severance Agreement and Release, dated May 22, 2008, by and between the Registrant, AAUSA and all of its subsidiaries and Ken Cieply, former Chief Financial Officer (included as Exhibit 10.5 of Quarterly Report on Form 10-Q (File No. 001-32697) filed August 15, 2008 and incorporated by reference herein)  |
| 10.39              | Promissory Note, dated December 19, 2008, between AAUSA, as maker, and Dov Charney, as payee (included as Exhibit 10.4 of Current Report on Form 8-K (File No. 001-32697) filed December 19, 2008 and incorporated by reference herein)   |
| 10.40+             | Employment Agreement, dated January 27, 2009, by and between Glenn A. Weinman and the Registrant (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed February 2, 2009 and incorporated by reference herein)  |

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| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 10.41              | Promissory Note, dated February 10, 2009, between AAUSA, as maker, and Dov Charney, as payee (included as Exhibit 10.1 of Current Report on Form 8-K (File No. 001-32697) filed February 12, 2009 and incorporated by reference herein)   |
| 10.42              | Credit Agreement, dated as of March 13, 2009, among the Company, certain subsidiaries of the Company, the facility guarantors party thereto, Lion Capital (Guernsey) II Limited, as initial lender, other lenders from time to time party thereto and Lion Capital LLP, as the administrative agent and the collateral agent (included as Exhibit 10.1 of the Current Report on Form 8-K (File No 001-32697) filed March 13, 2009 and incorporated by reference herein) |
| 10.43              | Letter Agreement Re: Extension of Non-Competition and Non-Solicitation Covenants in Section 5.27(a) of the Merger Agreement, dated March 13, 2009, among Dov Charney, Lion Capital (Guernsey) II Limited and the Registrant (included as Exhibit 10.6 of the Current Report on Form 8-K (File No 001-32697) filed March 16, 2009 and incorporated by reference herein)  |
| 14.1               | Registrant's Code of Ethics (included as Exhibit 14.1 of the Current Report for 8-K (File No. 001-32697) filed December 18, 2007 and incorporated by reference herein)  |
| 21.1*              | List of Subsidiaries  |
| 23.1*              | Consent of Marcum & Kliegman LLP  |
| 31.1*              | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2*              | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1*              | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2*              | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

\* Filed herewith.

+ Management contract or compensatory plan or arrangement.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

AMERICAN APPAREL, INC.

March 16, 2009

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature  | Title  | Date           |
|--|--|----------------|
| <i>/s/ DOV CHARNEY</i><br><b>Dov Charney</b>             | President, Chief Executive Officer and Director<br>(Principal Executive Officer) | March 16, 2009 |
| <i>/s/ ADRIAN KOWALEWSKI</i><br><b>Adrian Kowalewski</b> | Chief Financial Officer and Director (Principal<br>Financial Officer)            | March 16, 2009 |
| <i>/s/ MARK D. KLEIN</i><br><b>Mark D. Klein</b>         | Director   | March 16, 2009 |
| <i>/s/ ALLAN MAYER</i><br><b>Allan Mayer</b>             | Director   | March 16, 2009 |
| <i>/s/ KEITH MILLER</i><br><b>Keith Miller</b>           | Director   | March 16, 2009 |