

NITCHES INC  
Form 10-K  
December 20, 2004

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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### Form 10-K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended August 31, 2004

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.  
Commission File Number 0-13851

## NITCHES, INC.

(Exact name of registrant as specified in its charter)

California  
(State of Incorporation)

95-2848021  
(I.R.S. Employer Identification No.)

10280 Camino Santa Fe  
San Diego, California  
(Address of principal executive offices)

92121  
(Zip Code)

Registrant's telephone number: (858) 625-2633

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

Title of each class

Name of each exchange on which registered

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Common Stock, no par value

NASDAQ SmallCap Market

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Exchange Act). 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 the 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.

As of October 31, 2004, 1,171,169 shares of the Registrant's common stock were outstanding.

The aggregate market value of all equity held by non-affiliates of the Registrant as of the last business day of the most recently completed second fiscal quarter (February 29, 2004) based on the closing price of the Registrant's stock in the NASDAQ SmallCap Market on that date was \$6,734,222.

#### Documents Incorporated By Reference

## Edgar Filing: NITCHES INC - Form 10-K

Portions of the Definitive Proxy Statement, to be filed with the Commission and to be used in connection with the solicitation of proxies to be voted at the Registrant's annual meeting of shareholders scheduled to be held in February 2005, are incorporated by reference into Part III of this Report on Form 10-K.

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## PART I

### Item 1 - Business

#### *General*

Nitches, Inc. (the Company or Nitches) has been in the wholesale clothing business since 1973, and imports finished garments manufactured to its specifications from approximately ten foreign countries. The Company sells all-cotton and cotton blend knit and woven clothing for female and male consumers. Retail customers include Belk, Coopers, Gottschalks, Kohl's, Mervyn's, Sears, Sheplers, Stein Mart, TJ Maxx, Tractor Supply, and Wal-Mart (Sam's Club). The Company sells garments to these and other retailers through its own sales force and through independent sales representatives. Nitches provides fashionable clothing to the popularly priced market segment that generally retails between \$10 and \$35 per item. The Company competes primarily on the basis of price, quality, the desirability of its fabrics and designs, and the reliability of its delivery and service.

For more than ten years, the apparel market has been marked by deflation and reduced profit margins in certain markets. The consolidation of retail stores among a small number of national chains has given these chains leverage to seek lower pricing and thereby reduce profit margins for suppliers such as the Company. The Company's response has been to discontinue product lines in areas where it does not believe it can maintain a reasonable profit margin and to develop products in categories that are underserved or where the Company has an advantage in sources of supply, design or distribution.

The Company currently owns a total of 35 federally registered trademarks. While trademarks owned by the Company have always been important to its marketing and competitive strategy, prior to 1995 they were not central factors influencing its sales. However, subsequent to its reorganization in fiscal year 1995, the Company's trademarks in women's sleepwear and western wear and men's casual wear have become more important in identifying its products. Sleepwear garments are produced in a variety of fabrics and styles, including robes, pajamas, nightshirts and nightgowns, which are sold under the Body Drama® label and retailers' private labels. Western wear shirts are sold primarily under the Company labels Adobe Rose® and Southwest Canyon®. Western jeans are sold under the label Posted® through a licensing agreement with a third party supplier. The Company sells men's wear under the Newport Blue® and The Skins Game® labels through agreements with third parties.

#### *Product Development and Design*

The Company develops merchandise lines for production and distribution in two principal ways:

**Private Label Marketing** the Company works with major retailers in developing product lines which the Company then has manufactured and imported and which are generally sold under these retailers' private labels. The Company's sales personnel meet with buyers representing retailers who may specify products by style, fabric, and color. These buyers may provide samples to the Company or may select styles already available in Company showrooms. The Company has an established reputation for its ability to arrange for foreign manufacture on a reliable, expeditious and cost-effective basis.

**Branded Sales** the Company develops its own lines of clothing styles which are displayed in Company showrooms and which are also shown to retailers by independent sales representatives. The Company creates original garment bodies (styles) and more importantly, produces garments with original fabric prints and designs. The Company responds to frequent style changes in women's and men's clothing by maintaining a program of evaluating current trends in style and fabric. In an effort to continually stay abreast of fashion trends, representatives of the Company shop at exclusive department and specialty stores in the United States, Europe, Japan and other countries that are known to sell merchandise with advanced styling direction. The Company also seeks input from selected customers. The Company then selects styles, fabrics, and colors that it believes reflect current fashion trends.

**Sources of Supply**

Over 85% of the garments sold by the Company are manufactured abroad. Contracting with foreign manufacturers enables the Company to take advantage of prevailing lower labor rates, with the consequent ability to produce a quality garment that can be retailed in the popular, value and moderate price ranges. The Company arranges for the production of garments with suppliers on a purchase order basis, with each order generally backed by an irrevocable letter of credit. The Company does not have any long-term contractual arrangements with manufacturers. This provides the Company with flexibility regarding the selection of manufacturers for future production of goods. The Company believes that it could replace the loss of any particular manufacturer in any country within a reasonable time period. However, in the event of the loss of a major manufacturer the Company could experience a temporary interruption in supply.

As a result of import restrictions on certain garments imposed by bilateral trade agreements between the United States and certain foreign countries, the Company has sought diversity in the number of countries in which it has manufacturing arrangements. The percentage of total purchases from particular countries varies from period to period based upon quota availability and price considerations. The Company has arranged, and will continue to arrange, for production in the United States when economically feasible to meet specific needs.

The following table shows the percentage of the Company's total purchases, not including freight charges, duties and commissions, from each country for the years ended August 31, 2004, 2003, and 2002.

**Percent of Total Purchases by Country**

| Year ended August 31,                             | 2004 | 2003 | 2002 |
|---|------|------|------|
| Cambodia  | 27.6 | 34.4 | 6.8  |
| India   | 18.8 | 12.8 | 6.5  |
| Pakistan  | 16.5 | 2.7  |      |
| United States                                     | 14.5 | 7.7  | 5.0  |
| Sri Lanka   | 13.6 | 7.0  | 5.6  |
| Hong Kong   | 7.1  | 3.5  | 2.3  |
| United Arab Emirates                              | 0.7  | 18.7 | 60.9 |
| Macau   | 0.3  | 10.6 | 11.3 |
| Taiwan  | 0.2  | 2.1  |      |
| Countries less than .95% each in the current year | 0.7  | 0.5  | 1.6  |

The Company owns 100% of the outstanding capital stock of Nitches Far East Ltd., a Hong Kong corporation that performs production coordination, quality control and sample production services for the Company. Furthermore, the Company works with agents specializing in sourcing and production control in Cambodia, India, Pakistan and Sri Lanka. The Company and its subsidiary perform no material manufacturing and maintain no significant assets outside the United States.

In some cases, the manufacturer or agent with whom the Company contracts for production may subcontract work. Most of the listed countries have numerous suppliers that have the technical capability to manufacture garments of the type sold by the Company. The availability of alternate sources tends to offset the risk associated with the loss of a major manufacturer.

The Company believes that the production capacity of foreign manufacturers with which it has developed, or is developing, a relationship is adequate to meet the Company's production requirements for the foreseeable future. However, because of existing and potential import restrictions, the Company continues to attempt to diversify its sources of supply.

When management believes, based on previous experience and market performance, that additional orders for certain garments will be received, the Company may place production runs in amounts in excess of firm customer orders. This may allow the Company to achieve overall lower costs as well as to be able to respond more quickly to customer delivery requirements. However, the Company bears the consequent risk if garments purchased in advance of receipt of customer purchase orders do not sell.

### ***Raw Materials***

A substantial majority of the clothing sold by the Company is made of 100% cotton, although the Company also utilizes cotton blends, polyester and rayon fabrics. All of these fabrics are readily available in most countries in which the Company contracts for production and are easily imported to those countries that do not have an internal supply of such fabric. The majority of the fabric that the Company uses comes from multiple sources of supply in China. The Company is not dependent on a single source of supply for fabric that is not readily replaceable.

### ***Quality Control***

Company representatives regularly visit manufacturers to inspect garments and monitor production facilities in order to assure timely delivery, maintain quality control and issue inspection certificates. Furthermore, through these representatives and independent inspectors from major retailers, the Company ensures that the factories the Company uses for production adhere to policies consistent with prevailing labor laws. A sample of garments from a percentage of each production run is inspected before each shipment. Letters of credit arranged by the Company require, as a condition to the release of funds to the supplier, that a representative of the Company sign an inspection certificate.

### ***Marketing and Distribution***

The Company sells its products through an established sales network consisting of both in-house sales personnel and independent sales representatives. The Company does not generally advertise, although customers sometimes feature the Company's products in their advertisements. For both Company Brand and Private Label sales, employees operating in Company showrooms in New York City and Los Angeles represent the Company in soliciting orders nationally from approximately eight (8) major customers. In addition, senior managers of the Company have primary responsibility for sales to certain key accounts. The Company's products are also marketed by 54 independent commissioned sales representatives.

Increasingly, major retail chains are limiting the apparel they carry to nationally branded merchandise. The term nationally branded generally refers to an apparel brand that is sold throughout the country and is supported by national marketing programs such as direct advertisements in magazines and newspapers. Although the Company does sell branded apparel under owned and licensed trademarks, none of these lines are considered national brands. As the trend towards national brands continues, the Company may face fewer retail channels for the distribution of its products, leading to a decline in sales, or be forced to support its brands through national marketing programs, requiring an increase in expenditures.

Most garments are shipped by suppliers in bulk form to the Company's warehouse in San Diego, where they are sorted, stored and packed for distribution to customers. From time to time, the Company may rent additional short-term warehouse space as needed to accommodate its requirements during peak shipping periods. In addition, to facilitate shipping to customers, some of its overseas suppliers perform sorting, price ticketing, hanging, and packing functions.

Purchase orders may be canceled by the Company's customers in the event of late delivery or in the event of receipt of nonconforming goods. Late deliveries usually are attributable to production or shipping delays beyond the Company's control. In the event of canceled purchase orders, rejections or returns, the Company will sell garments to other retailers, off-price discount stores or garment jobbers. In the past the Company has often been able to recover from its manufacturers some portion of its expenses or losses associated with sales below cost for causes attributable to manufacturing problems. However, the Company has also historically experienced losses on merchandise that is rejected or returned. Yet past losses on rejected and returned merchandise have not been material to the Company.

The Company's business is concentrated on certain significant customers. Sales to Wal-Mart (Sam's Club) and Kohl's accounted for 32.3% and 31.3%, respectively, of the Company's net sales during fiscal 2004. Kohl's, Mervyn's, and Sears accounted for 29.2%, 16.9% and 6.5%, respectively, of the Company's net sales in fiscal 2003. While the Company believes its relationships with its major customers are good, because of competitive changes and availability of the types of garments sold by the Company from a number of other suppliers, there is the possibility that any customer could alter the amount of business it does with the Company. If the Company experiences a significant decrease in sales to any of its major customers, and is unable to replace such sales volume with sales to other major customers, there could be a material adverse financial effect on the Company.

### ***Import Restrictions***

The ability of the Company to import garments is regulated by import restrictions that limit the specific number of garments that may be imported from any country during a specific period. Government import quotas of various types are imposed on substantially all of the products imported by the Company from substantially all of the countries from which the Company purchases garments. Because of these quota restrictions, the Company has sought diversity in the number of countries in which it has garments manufactured.

The Agreement on Textile and Clothing (the ATC), which became effective on January 1, 1995, provided the basic guidelines for administering import quotas and related matters. The ATC contains three provisions that affect the Company's business to varying degrees. First, the ATC required that import quotas be phased out in four stages over a ten-year period. Quotas on substantially all of the garments imported by the Company are scheduled to be phased out as of January 1, 2005. Through existing manufacturers, the Company has planned for production sourcing out of China beginning in early 2005. Second, over the first six years, import tariffs were reduced from an average of 19% to 17.5%. While the tariff reductions apply to most apparel items, the sizes of the reductions are extremely small and have not had a material impact on the Company's overall cost of merchandise. Finally, new rules of origin took effect on July 1, 1996 whereby the country in which the garment is assembled is deemed the country of origin instead of the country in which the fabric is cut. The biggest impact of the rule change has been on garments produced in China, which assembles large quantities of apparel cut in nearby countries such as Macau, Hong Kong and Taiwan. Approximately 7.6% of the Company's garments were produced in Macau, Hong Kong and Taiwan in fiscal 2004. The Company has not experienced any disruption in its garment purchases as a result of the country of origin rule change.

The Company closely monitors the status of applicable import quotas and the extent to which they are being filled. The Company bases its production decisions, in part, on whether a particular supplier country has entered into an agreement with the United States restricting trade in certain garments and, if so, the extent to which the applicable quota imposed for a particular year is expected to be filled by a scheduled shipment date. In some cases, the Company has responded to the anticipated exhaustion of a particular quota by having goods manufactured and shipped prior to the receipt of purchase orders or well in advance of scheduled delivery dates in order to be assured that garments will be imported into the United States before the applicable quota is filled. In these instances, the Company is required to hold garments in inventory, sometimes for several months, before shipment to customers. This can occur, normally, toward the end of a calendar year.

Import restrictions have, in some cases, increased the cost of finished goods to the Company as a result of increased competition for a restricted supply of goods. The Company's future results may also be affected by additional bilateral or unilateral trade restrictions, a significant change in existing quotas, political instability resulting in the disruption of trade from exporting countries, or the imposition of additional duties, taxes and other charges on imports.

Because of import restrictions and quotas, embargos, and political instability in some countries of origin, the Company may be unable, from time to time, to import certain types of garments. Because of the Company's dependence on foreign suppliers, a significant tightening or utilization of import quotas for the types of garments imported by the Company, applicable to a substantial number of countries from which the Company imports, could force the Company to seek other sources of supply and to take other actions which could increase costs of production. This could also cause delays in production and result in cancellation of orders. Any of these factors could result in an adverse financial impact on the Company.

The Company believes it has the ability to locate, establish relationships with and develop manufacturing sources in countries where the Company has not previously operated. Whenever possible, the Company moves production to countries in which applicable quotas remain unfilled or to countries in which no quotas are imposed. The Company may also shift production to non-quota garments if a market for such garments exists. The time required to commence contract production in supplier countries ranges from several weeks in the case of a country with a relatively well developed garment manufacturing industry to four months or more for a country in which there are less developed capabilities. The cost to the Company of arranging for production in a country generally involves management time and associated travel expenses.

### ***Backlog***

At August 31, 2004 and August 31, 2003 the Company had unfilled customer orders of \$10.5 million and \$12.2 million, respectively, with such orders generally scheduled for delivery by February 2005 and 2004, respectively. The decrease in order backlog was primarily in the Company's men's wear product line due to a delay in anticipated order

placement from Sam's Club and Kohl's as they looked to place orders closer to requested delivery dates in order to more accurately anticipate consumer demand. The amount of unfilled orders at any given time is affected by a number of factors, including the timing of the receipt and processing of customer orders and the scheduling of the manufacture and shipping of the product, which may be dependent on customer requirements.

As of November 30, 2004, the Company had on-hand unfilled customer orders of \$12.9 million as compared to \$14.9 million at November 30, 2003, with such orders generally scheduled for delivery by May 2005 and 2004, respectively. The decrease in backlog is due to the inability of the Company to secure a renewal of \$7.9 million in men's wear orders from Sam's Club, offset partially by increased orders from other men's wear and sleepwear customers.

Backlog amounts include both confirmed orders and unconfirmed orders that the Company believes, based on industry practice and past experience, will be confirmed. While cancellations, rejections and returns have generally not been material in the past, there can be no assurance that such action by customers will not reduce the amount of sales realized from the backlog of orders at November 30, 2004.

### ***Competition***

The apparel industry is highly competitive and consists of many manufacturers and distributors, none of which accounts for a significant percentage of total sales, but many of which are larger and have substantially greater resources than the Company. The Company competes with a number of companies which import clothing from abroad for wholesale distribution, with domestic retailers having established foreign manufacturing capabilities and with domestically produced goods. Management believes that the Company competes upon the basis of price, quality, the desirability of its fabrics and styles, and the reliability of its service and delivery. In addition, the Company has developed long-term working relationships with manufacturers and agents, which presently provide the Company with reliable sources of supply. Increasingly the Company competes directly with agents or with retailers' own sourcing affiliates who own factories or have established production relationships that allow these companies to directly supply retailers with the desired product at a lower cost.

### ***Employees***

The Company's ability to compete effectively is dependent, in part, on its ability to retain managerial personnel with experience in locating, developing and maintaining reliable sources of supply and to retain experienced sales and product development personnel. As of August 31, 2004, the Company had 40 full-time employees, of whom nine worked in executive, administrative or clerical capacities and 23 worked in sales, design, and production. Additionally, the Company employs eight individuals in its Hong Kong office who are responsible for fabric and trim sourcing, product development and quality control. The Company may also employ temporary personnel on a seasonal basis. None of the Company's employees is represented by a union. The Company considers its working relationships with its employees to be good and has never experienced an interruption of its operations due to any kind of labor dispute. The Company contracts with an unrelated entity to provide warehouse services.

### ***Investments***

On October 1, 2002, the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc. (NAP), a New York-based intimate apparel company. NAP is a leading designer, marketer and distributor of women's sleepwear, robes, loungewear, daywear and foundations in the United States. Designer Intimates acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC which was later assumed by CIT that is secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. The Company has guaranteed \$3.0 million of this credit line and this guaranty formed the consideration from the company for its 28% ownership interest in Designer Intimates. In the event of a call on this guaranty by CIT, Nitches has a contract with the remaining shareholders of Designer Intimates to limit Nitches' exposure to 28% of the called value, subject to the maximum guaranty of \$3.0 million. The major shareholder in Designer Intimates is Haresh T. Tharani, Chairman of Bill Blass, Ltd. The Company and Mr. Tharani have a relationship that began in 1995 when the company sold its junior sportswear business to a company also owned by Mr. Tharani, Design & Source Holding Company. Steven Wyandt serves on the boards of directors of NAP and Designer Intimates.

Designer Intimates sells robes, loungewear, and sleepwear under its owned label of Anne Lewin. It also sells similar product lines under distribution and licensing agreements. The brands that these include are Argentovivo, Princess Tam Tam, Crabtree & Evelyn, Bill Blass Lifestyle, Dockers, and Vasserette. In addition, private label product is sold to such major retailers as Victoria Secret, Pennys, and The Disney Stores.

There are additional disclosures regarding this investment in the Equity Investment discussion on page 11 and page 26 presents condensed financial statements for Designer Intimates.





***Cautionary Statement Under the Private Securities Litigation Reform Act of 1995***

Statements in the annual report on Form 10-K under the caption "Business", as well as oral statements that may be made by the Company or by officers, directors or employees of the Company acting on the Company's behalf, that are not historical fact constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements involve known and unknown risks and uncertainties that may cause the Company's actual results in future periods to differ materially from forecasted results. Those risks include a softening of retailer or consumer acceptance of the Company's products, pricing pressures, competitive forces, worldwide political instability, or unanticipated loss of a major customer. In addition, the Company's business, operations and financial condition are subject to reports and statements filed from time to time with the Securities and Exchange Commission.

**Item 2 - Properties**

The Company currently leases properties in New York, California and Hong Kong. The Company leases one showroom in New York, one in Los Angeles and approximately 30,000 square feet of warehouse with administrative offices in San Diego. The Company may lease additional short-term warehouse space from time to time as needed.

**Item 3 - Legal Proceedings**

By letter dated December 6, 2004, the Company, together with Steve Wyandt and Paul Wyandt, were served notice by the U.S. Department of Labor that a complaint has been filed with the office of Occupational Safety & Health Administration by Angel Martin Aquino alleging discriminatory employment practices in violation of Section 806 of the Corporate and Criminal Fraud Accountability Act of 2002 (also known as the Sarbanes-Oxley Act). OSHA has not yet spoken with, or received any information from, the Company or Messrs. Steve or Paul Wyandt, and the December 6 letter indicates that OSHA has not yet determined whether an investigation of this matter is appropriate. Mr. Aquino was retained by the Company earlier this year to provide consulting services to the Company. Mr. Aquino is seeking alleged actual and compensatory damages of \$43,000 and \$300,00, respectively. The Company believes that the claims asserted by Mr. Aquino are without merit and intends to vigorously defend against such claims.

**Item 4 - Submission of Matters to a Vote of Security Holders**

There were no matters submitted to a vote of security holders during the fourth quarter of fiscal 2003.

**PART II****Item 5 - Market for the Registrant's Common Stock and Related Shareholder Matters**

The Company's Common Stock trades on The NASDAQ SmallCap Market under the symbol NICH. The number of shareholders of record of the Common Stock on October 31, 2004 was 115. The Company believes that there are a significant number of beneficial owners of its Common Stock whose shares are held in street name. The closing sales price of the Common Stock on October 29, 2004 was \$5.80 per share.

The high and low closing sale prices, adjusted for stock dividends, for each fiscal quarter ending on the specified date during the last two fiscal years were as follows:

|  | <u>High</u> | <u>Low</u> |
|--|-------------|------------|
| <b>FISCAL YEAR ENDED AUGUST 31, 2004</b> |             |            |
| First Quarter                            | \$ 5.16     | \$ 3.87    |
| Second Quarter                           | 6.25        | 3.63       |
| Third Quarter                            | 8.69        | 5.10       |
| Fourth Quarter                           | 8.98        | 4.83       |
| <b>FISCAL YEAR ENDED AUGUST 31, 2003</b> |             |            |
| First Quarter                            | \$ 7.31     | \$ 5.78    |
| Second Quarter                           | 9.02        | 6.30       |
| Third Quarter                            | 9.78        | 6.49       |
| Fourth Quarter                           | 6.50        | 5.00       |

The Company does not have a quarterly dividend policy and did not pay or declare any dividends during fiscal year 2004. However, during fiscal year 2003, the Company declared and paid the following special dividends:

| <u>Date Paid</u>  | <u>Dividends per share</u> |
|-------------------|----------------------------|
| November 26, 2002 | .05                        |
| January 29, 2003  | .15                        |
| April 23, 2003    | .05                        |
| July 29, 2003     | .05                        |

**Item 6 - Selected Financial Data** (In thousands, except per share amounts)**OPERATING RESULTS DATA:**

|   | Fiscal Year Ended August 31,             |           |           |           |           |
|---|--|-----------|-----------|-----------|-----------|
|   | 2004                                     | 2003      | 2002      | 2001      | 2000      |
|   | (In thousands, except per share amounts) |           |           |           |           |
| Net sales   | \$ 32,179                                | \$ 28,440 | \$ 29,589 | \$ 33,780 | \$ 39,471 |
| Cost of goods sold                                | 22,783                                   | 21,856    | 22,214    | 24,854    | 29,156    |
| Gross profit                                      | 9,396                                    | 6,584     | 7,375     | 8,926     | 10,315    |
| Selling, general and administrative               | 8,389                                    | 7,663     | 7,132     | 7,313     | 7,403     |
| Income (loss) from operations                     | 1,007                                    | (1,079)   | 243       | 1,613     | 2,912     |
| Other income                                      |  | 3         | 16        | 247       | 20        |
| Interest expense                                  | (93)                                     | (83)      | (80)      | (162)     | (100)     |
| Loss from equity investment                       | 14                                       | (236)     |           |           |           |
| Income (loss) before income taxes                 | 928                                      | (1,395)   | 179       | 1,698     | 2,832     |
| Provision for (benefit from) income taxes         | 371                                      | (425)     | 63        | 615       | 946       |
| Net income (loss)                                 | \$ 557                                   | \$ (970)  | \$ 116    | \$ 1,083  | \$ 1,886  |
| Basic earnings per share                          | \$ .48                                   | \$ (0.83) | \$ 0.10   | \$ 0.92   | \$ 1.61   |
| Diluted earnings per share                        | \$ .48                                   | \$ (0.83) | \$ 0.10   | \$ 0.92   | \$ 1.61   |
| Cash dividends per common share                   | \$                                       | \$ 0.30   | \$ 0.45   | \$ 1.35   | \$ 1.65   |
| Weighted average number of common shares (000 s): |  |           |           |           |           |
| Basic   | 1,171                                    | 1,171     | 1,112     | 1,172     | 1,172     |
| Diluted   | 1,171                                    | 1,171     | 1,112     | 1,172     | 1,172     |

**CONSOLIDATED BALANCE SHEETS DATA:**

|                                       | As of August 31 |          |          |          |          |
|---------------------------------------|-----------------|----------|----------|----------|----------|
|                                       | 2004            | 2003     | 2002     | 2001     | 2000     |
|                                       | (In thousands)  |          |          |          |          |
| Cash                                  | \$ 219          | \$ 110   | \$ 182   | \$ 192   | \$ 314   |
| Receivables                           | 3,587           | 922      | 4,523    | 3,179    | 4,262    |
| Income taxes receivables              |                 | 466      | 118      | 75       |          |
| Inventories                           | 3,373           | 4,974    | 5,306    | 5,408    | 5,055    |
| Total current assets                  | 7,556           | 6,721    | 10,378   | 9,157    | 9,857    |
| Total assets                          | 7,622           | 6,847    | 10,503   | 9,289    | 10,011   |
| Accounts payable and accrued expenses | 1,885           | 1,707    | 4,277    | 2,684    | 2,951    |
| Total current liabilities             | 1,939           | 1,707    | 4,277    | 2,684    | 3,049    |
| Shareholders' equity                  | \$ 5,461        | \$ 4,904 | \$ 6,226 | \$ 6,605 | \$ 6,692 |
| <b>Other Financial Information:</b>   |                 |          |          |          |          |
| Gross margin                          | 29.2%           | 23.5%    | 25.1%    | 26.6%    | 26.1%    |
| Operating margin (deficit)            | 3.1%            | (3.8)%   | 0.8%     | 4.8%     | 7.4%     |
| Net income as a percent of sales      | 1.7%            | (3.4)%   | 0.4%     | 3.2%     | 4.8%     |
| <b>Liquidity:</b>                     |                 |          |          |          |          |
| Current ratio                         | 3.90            | 3.94     | 2.46     | 3.41     | 3.23     |
| Working capital                       | \$ 5,617        | \$ 5,014 | \$ 6,101 | \$ 6,473 | \$ 6,808 |

Item 7 -

**Nitches, Inc and Subsidiaries**  
**Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Cautionary Statement Under the Private Securities Litigation Reform Act of 1995**

Statements in the annual report on Form 10-K under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations", as well as oral statements that may be made by the Company or by officers, directors or employees of the Company acting on the Company's behalf, that are not historical fact constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements involve known and unknown risks and uncertainties that may cause the Company's actual results in future periods to differ materially from forecasted results. Those risks include, among others, a softening of retailer or consumer acceptance of the Company's products, pricing pressures and other competitive forces, or unanticipated loss of a major customer. In addition, the Company's business, operations and financial condition are subject to reports and statements filed from time to time with the Securities and Exchange Commission.

**Critical Accounting Policies**

Several of the Company's accounting policies involve significant judgments and uncertainties. The policies with the greatest potential effect on the Company's results of operations and financial position include the estimated collectibility of accounts receivable and the recovery value of obsolete or overstocked inventory.

*Revenue Recognition.* The Company recognizes revenue at the time products are shipped based on its terms of F.O.B. shipping point, where risk of loss and title transfers to the buyer at time of shipment. The Company records sales in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Under these guidelines, revenue is recognized when all of the following exist: persuasive evidence of a sale arrangement exists, delivery of the product has occurred, the price is fixed or determinable and payment is reasonably assured. Provisions are made currently for estimated product returns and sales allowances.

*Allowances for Sales Returns, Doubtful Accounts and Other.* Sales are recorded net of estimated future returns, uncollectible accounts receivable and other customer related allowances. Management analyzes historical returns and bad debt expense, current economic trends, changes in customer demand and sell-through of our products when evaluating the adequacy of these allowances. In addition, the Company may provide warehousing credits and other allowances to certain customers in accordance with industry practice. These reserves are determined based on historical experience, budgeted customer allowances and existing commitments to customers. Although management believes it has established adequate reserves with respect to these items, actual activity could vary from management's estimates and such variances could have a material impact on reported results. At August 31, 2004, trade accounts receivable balance was \$3.6 million, net of allowances of \$492,000 and factor advances of \$1.9 million as compared to a balance of \$894,000, net of allowances of \$549,000 and factor advances of \$1.5 million at August 31, 2003.

*Inventory.* The Company marks down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated net realizable value based on assumptions about age of the inventory, future demand and market conditions. This process provides for a new basis for the inventory until it is sold. If actual market conditions are less favorable than those projected by management, additional inventory markdowns may be required. The Company's inventory balance was \$3.4 million, net of inventory markdowns of \$85,000, at August 31, 2004, as compared to an inventory balance of \$5.0 million, net of inventory markdowns of \$140,000, at August 31, 2003.

**Results of Operations**

*Years Ended August 31, 2004 and 2003*

Net sales for the fiscal year ended August 31, 2004 increased approximately \$3.7 million or 13.1% compared to the fiscal year ended August 31, 2003 due to an increase in unit sales in the Company's men's wear line resulting from the addition of a few large customers. Cost of sales as a percent of net sales decreased by 6% leading to an increase in gross profit margin from 23.2% to 29.2% between fiscal 2003 and 2004. This gross margin increase came as a result of the increased sales volume in the Company's men's wear line, which has historically generated higher gross margins than the Company's average realized gross margin.

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The Company's product mix constantly changes to reflect customer mix, fashion trends and changing seasons. Consequently, gross margins are likely to vary on a quarter-to-quarter basis and in comparison to gross margins generated in prior fiscal years.

Selling, general and administrative expenses increased in dollar amount from \$7.7 million in fiscal 2003 to \$8.4 million in fiscal 2004, primarily due to increased sales commission expenses as a result of the Company's sales mix shifting from non-commissioned sleepwear sales to commissioned men's wear sales. On a percent of net sales basis, selling, general and administrative expenses declined from 26.9% in fiscal 2003 to 26.1% in fiscal 2004, due primarily to the increase in sales volume in the Company's men's wear line. Management continually monitors expense levels and strives to maintain streamlined operations while making investments intended to generate optimal sales performance.

Interest expense increased \$10,000 for the current year to \$93,000 as compared to \$83,000 for the year ended August 31, 2003. This 12% increase was due to more advances made under the Company's factoring agreement in line with larger inventory purchases from January through April, during which time the majority of the Company's increase in annual sales volume was concentrated.

### *Years Ended August 31, 2003 and 2002*

Net sales for the fiscal year ended August 31, 2003 decreased approximately \$1.2 million or 3.9% compared to the fiscal year ended August 31, 2002 due to a decrease in unit sales in both the Company's sleepwear and western wear product lines, resulting from the general slowdown in the economy continued from fiscal 2002. Furthermore, cost of sales as a percent of net sales increased by 1.8%, leading to a decline in gross profit margin from 24.9% to 23.2% between fiscal 2002 and 2003. This decrease came as a result of lower realized gross margins across all product lines.

The Company's product mix constantly changes to reflect customer mix, fashion trends and changing seasons. Consequently, gross margins are likely to vary on a quarter-to-quarter basis and in comparison to gross margins generated in prior fiscal years.

Selling, general and administrative expenses increased in dollar amount from \$7.1 million in fiscal 2002 to \$7.7 million in fiscal 2003, primarily due to increased sales commission expenses as a result of the Company's sales mix shifting from non-commissioned sleepwear sales to commissioned men's wear sales. On a percent of net sales basis, selling, general and administrative expenses increased from 24.1% in fiscal 2002 to 26.9% in fiscal 2003, due primarily to the decrease in sales volume as well as the dollar increase in selling, general and administrative expenses. Management continually monitors expense levels and strives to maintain streamlined operations while making investments intended to generate optimal sales performance.

### **Equity Investment**

In October 2002, the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC which was later assumed by CIT, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guaranty formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. In the event of a call on this guaranty by CIT, Nitches has a contract with the remaining shareholders of Designer Intimates to limit Nitches' exposure to 28% of the called value, subject to the maximum guaranty of \$3.0 million.

Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For fiscal year ended August 31, 2004, the Company recognized a gain of \$14,000 from the unconsolidated subsidiary. This gain is non-cash income and is not taxable to the Company. For that same period in fiscal 2004, Designer Intimates earned \$49,000 on sales of \$68.3 million.

Nitches has introduced Designer Intimates to the factories that Nitches uses for its own sleepwear product line. This provides access to a lower cost production base than Designer Intimates has had in Turkey where it has historically produced over ninety percent of its products which are predominantly robes and lounge wear. In an agreement with Designer Intimates, Nitches has produced a line of sleepwear under the Dockers label. This product contributed approximately \$1.4 million dollars of sales for Nitches in fiscal year 2004. As of August 31, 2004, Nitches had a backlog of approximately \$1.8 million for this product line.

## Liquidity and Capital Resources

Working capital increased to \$5.6 million at August 31, 2004 as compared to \$5.0 million at August 31, 2003, due to an increase in accounts receivable in excess of a related increase in current liabilities. A \$2.4 million increase in fourth quarter sales versus the prior year and extended credit terms required by certain customers generated a higher current year accounts receivable balance of \$3.6 million versus \$894,000 at the end of the prior year. The working capital effect of the accounts receivable increase was partially offset by a related increase in current liabilities for purchases made in support of the noted sales increase. However, the Company's current ratio decreased slightly to 3.90 at August 31, 2004 from 3.94 at August 31, 2003, due to the higher proportional increase in current liabilities at the end of the current fiscal year.

The Company sells substantially all of its trade receivables to a factor (CIT) on a pre-approved, non-recourse basis. The Company attempts to make any recourse shipments on a COD basis or ensure that the customers' payments are backed by a commercial or standby letter of credit issued by the customers' bank. The amount of the Company's receivables which were recourse and were not made on a COD basis or supported by commercial or standby letters of credit at August 31, 2004 was approximately \$1.0 million of which approximately \$507,000 had been collected through September 30, 2004.

Payment for non-recourse factored receivables is made at the time customers make payment to CIT or, if a customer is financially unable to make payment, within approximately 180 days of the invoice due date. Under the factoring agreement, the Company can request advances in anticipation of customer collections at CIT's prime rate (currently 4.5%) less one and one-half percent (1.5%). The amount of advances available to the Company is limited to eighty-five percent (85%) of non-recourse factored receivables.

The factoring agreement does not contain any financial covenants to which the Company must adhere. Advances are collateralized by all of the assets of the Company as well as a personal guaranty of the Company's Chairman Steven Wyandt. This guaranty allows CIT to recover up to \$1 million from Mr. Wyandt to offset any losses incurred in the event of liquidation. In January 2004, Mr. Wyandt loaned \$90,000 to the Company to meet short-term cash requirements of the business. The Company's factor at that time, HSBC, had restricted advance availability due to the sale of HSBC's factoring business to CIT, which was announced on December 31, 2003 with a closing date of February 28, 2004. The loan from Mr. Wyandt was repaid by the Company in February 2004.

The factoring agreement can be terminated by CIT on 30-days written notice. The company believes the factoring agreement with CIT, along with expected cash flow from operating activities and current levels of working capital are adequate to fulfill the Company's liquidity needs for the foreseeable future.

The Company may also issue letters of credit through CIT for the purchase of inventory in the normal course of its operations. Letters of credit are subjected to a limit of \$6.0 million. At August 31, 2004, the Company had outstanding letters of credit of approximately \$2.4 million for the purchase of finished goods, which had been opened through CIT.

During fiscal 2004, the Company did not declare or pay any cash dividends. During fiscal 2003, the Company declared and paid cash dividends of \$0.30 per share. The Company does not have a stated dividend policy. On a quarterly basis the board evaluates the ability to pay dividends based upon profitability and financing needs.

### Contractual Obligations and Commercial Commitments

The following table illustrates the Company's contractual obligations and commercial commitments as of August 31, 2004:

|  | Payments due/Commitments expiring per period |                     |                   |                     |                 |
|--|--|---------------------|-------------------|---------------------|-----------------|
|  | Total Amounts<br>Committed                   | Less than<br>1 year | 1 - 3 years       | 4 - 5 years         | Over<br>5 years |
| Operating leases                           | \$ 653,000                                   | \$ 363,000          | \$ 290,000        |                     |                 |
| Letters of credit                          | 2,390,000                                    | 2,390,000           |                   |                     |                 |
| Guarantees                                 | 3,000,000                                    |                     |                   | 3,000,000*          |                 |
| <b>Total obligations &amp; commitments</b> | <b>\$ 6,043,000</b>                          | <b>\$ 2,753,000</b> | <b>\$ 290,000</b> | <b>\$ 3,000,000</b> | <b>\$</b>       |

\* Due on demand

### Inventory

In its ordinary course of operations, the Company generally makes some sales below its normal selling prices or below cost. Based on experience, management believes this will be true for some inventory held on or acquired after August 31, 2004. The amount of such sales depends on several factors, including general economic conditions, market conditions within the apparel industry, the desirability of the styles held in inventory and competitive pressures from other garment suppliers.

The Company's inventory decreased from \$5.0 million at August 31, 2003 to \$3.4 million at August 31, 2004. The Company has established an inventory markdown reserve as of August 31, 2004, which management believes will be sufficient for current inventory that is expected to be sold below cost in the future. There can be no assurance that the Company will realize its expected selling prices or that the inventory markdown reserve will be adequate for items in inventory as of August 31, 2004 for which customer sales orders have not yet been received. The inventory markdown reserve is calculated based on specific identification of aged goods and styles that are slow-moving or selling off-price.

### Impact of Exchange Rates

While the Company purchased over 85% of its products from foreign manufacturers in fiscal 2004, all of its purchases are denominated in United States dollars. Because the Company's products are sold primarily in the United States in dollar denominated transactions, the Company does not engage in currency hedging to reduce currency risk. A prolonged increase in the value of the dollar versus foreign currencies could enhance the Company's purchasing power for new purchase orders and reduce its cost of goods sold. Conversely, a prolonged decrease in the value of the dollar relative to foreign currencies could result in an increase in the Company's cost of manufacturing for new purchase orders and costs of goods sold.

### Impact of Inflation and Deflation

Management does not believe that inflation has had any material impact upon the Company's revenues or income from operations to date. Management believes that the apparel sector in which the Company operates continues to experience deflation, contrary to the modest inflation experienced in the economy in general. The persistence of the consumer to buy on sale merchandise has put pressure on retail gross margins, which in turn has led to downward pressure from retailers on wholesale gross margins, in the form of lower negotiated purchase prices as well as selling cost adjustments taken as deductions against invoices issued by the Company. In the apparel industry, these selling cost adjustments are commonly referred to as markdown allowances or chargebacks. Without a corresponding decrease in fabric and labor prices, these markdown allowances have led to a decline in wholesale gross margins. The Company incurred \$750,000 in markdown allowances in fiscal 2004, a reduction from fiscal 2003 when a doubling of such allowances in comparison to fiscal 2002 to \$1.2 million contributed to an operating loss. Management believes these deflationary pressures will continue into the foreseeable future.

### Future Operating Results

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Business conditions in the apparel sector continue to be characterized by limited consumer demand and persistent discounting of merchandise by retailers. The continuing conflict in Iraq, coupled with the ongoing uncertainty of the overall economy and the propensity of consumers to seek on sale merchandise has sustained the use of significant discounting by most retailers to stimulate sales. In general, retailers have to sell more units in order to achieve sales equal to last year. The Company does not expect significant improvement in business conditions in the apparel sector for the upcoming fiscal year. In view of the market uncertainties and economic pressures facing the Company, management remains conservative in its approach to the upcoming fiscal year.

### **Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.



### Recently Issued Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ( FASB ) issued Interpretation ( FIN ) No. 46, Consolidation of Variable Interest Entities. Until this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 requires a variable interest entity, as defined, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns. FIN No. 46 is effective for reporting periods ending after December 15, 2003. In December 2003, the FASB issued Interpretation 46R (FIN 46R), a revision to FIN 46. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after March 15, 2004. The adoption of this interpretation did not have a significant impact on the Company's financial statements.

In April 2003, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 149 ( SFAS No. 149 ), Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The provisions of this statement will be applied prospectively. This statement amends SFAS 133 for decisions made in the derivatives project implementation process, in connection with other FASB projects dealing with financial instruments, and in connection with implementation issues related to the definition of a derivative. The adoption of SFAS 149 has not had any impact on the financial statements.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ( SFAS No. 150 ), Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This statement requires that certain financial instruments which had previously been classified as equity be classified as liabilities. The Company has no outstanding securities that meet the criteria of SFAS No. 150 and, therefore, this statement will not have any impact on our financial statements.

In March 2004, the FASB issued an exposure draft Share-Based Payment An Amendment of FASB Statements No. 123 and 95. The exposure draft addresses the accounting for transactions in which a company receives employee services in exchange for equity instruments of the company or liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of equity instruments. The Company does not currently have any stock options or similar instruments issued or outstanding, therefore these statements are not expected to have any impact on the Company's financial statements.

### **Certain Business Risk Factors**

***We rely on a few key customers, and the loss of any one key customer would substantially reduce our revenues.***

We derive a significant amount of our revenues from a few major customers. A significant decrease in business from or loss of any of our major customers could harm our financial condition by causing a significant decline in revenues attributable to such customers.

The Company's business is concentrated on certain significant customers. Sales to Wal-Mart (Sam's Club) and Kohl's accounted for 32.3% and 31.3%, respectively, of the Company's net sales during fiscal 2004. Kohl's, Mervyn's, and Sears accounted for 29.2%, 16.9% and 6.5%, respectively, of the Company's net sales in fiscal 2003. While the Company believes its relationships with its major customers are good, we do not have long-term contracts with any of them and purchases generally occur on an order-by-order basis. Because of competitive changes and the availability of the types of garments sold by the Company from a number of other suppliers, there is the possibility that any customer could alter the amount of business it does with the Company. If the Company experiences a significant decrease in sales to any of its major customers, and is unable to replace such sales volume with orders from other major customers, there could be a material adverse financial effect on the Company.

***Our business depends on consumer spending patterns.***

Our business is sensitive to a number of factors that influence the levels of consumer spending, including political and economic conditions such as recessionary environments, the levels of disposable consumer income, consumer debt, interest rates and consumer confidence. Reduced consumer spending on apparel and accessories could have an adverse effect on our operating results.

***We operate in a highly competitive and fragmented industry and our failure to successfully compete could result in a loss of one or more significant customers.***

The retail apparel industry is highly competitive and fragmented. Our competitors include numerous apparel designers, manufacturers, importers and licensors, many of which have greater financial and marketing resources than us. We believe that the principal competitive factors in the apparel industry are:

- timeliness, reliability and quality of services provided,
- price,
- brand name and brand identity, and
- the ability to anticipate customer requirements and consumer demand.

If we do not continue to provide high quality and reliable services on a timely basis at competitive prices, we may not be able to continue to compete in our industry. If we are unable to compete successfully, we could lose one or more of our significant customers which, if not replaced, could negatively impact our sales and financial performance.

***We must successfully gauge fashion trends and changing consumer preferences to succeed.***

Our failure to anticipate, identify and respond effectively to changing consumer demands and fashion trends could adversely affect acceptance of our products by retailers and consumers and may result in a significant decrease in net sales or leave us with a substantial amount of unsold inventory. We believe that our success depends on our ability to anticipate, identify and respond to changing fashion trends in a timely manner. Our products must appeal to a broad range of consumers whose preferences cannot be predicted with certainty and are subject to rapid change. If our products are not successfully received by retailers and consumers and we are left with a substantial amount of unsold inventory, we may be forced to rely on markdowns or promotional sales to dispose of excess, slow-moving inventory. If this occurs, our business, financial condition, results of operations and prospects may be harmed.

***We depend on our key personnel.***

Our success depends to a large extent upon the continued services of our officers and managers. The loss of the services of any key member of management could have a material adverse effect on our ability to manage our business. Our continued success is dependent upon our ability to attract and retain qualified management, administrative and sales personnel to support our future growth. Our inability to do so may have a significant negative impact on our ability to manage our business.

### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

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Market risk represents the potential impact to our financial position, results of operations or cash flows due to adverse changes in the financial markets. We are exposed to market risk from changes in the base interest rate of our variable rate debt. A 1% change in interest rates would increase or decrease our annual interest expense by approximately \$23,000.

**Item 8 - Financial Statements and Supplementary Data**

**Nitches, Inc. and Subsidiaries**

***Index to Consolidated Financial Statements Filed with  
the Annual Report of the Company on Form 10-K***

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Shareholders  
Nitches, Inc.  
San Diego, California

We have audited the accompanying consolidated balance sheets of Nitches, Inc. and subsidiaries as of August 31, 2004 and 2003 and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three-year period ended August 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 financial position of Nitches, Inc. and subsidiaries as of August 31, 2004 and 2003 and the results of their operations and their cash flows for each of the years in the three-year period ended August 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Los Angeles, California  
October 22, 2004

**NITCHES, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**

|  | August 31,   |              |
|--|--------------|--------------|
|  | 2004         | 2003         |
| <b>ASSETS</b>  |              |              |
| Current assets:  |              |              |
| Cash   | \$ 219,000   | \$ 110,000   |
| Receivables:   |              |              |
| Trade accounts, less allowances (\$492,000 in 2004 and \$549,000 in 2003)  | 3,555,000    | 894,000      |
| Due from affiliates and employees  | 32,000       | 28,000       |
|  | 3,587,000    | 922,000      |
| Total receivables  |              |              |
| Refundable income taxes  |              | 466,000      |
| Inventories, less allowances (\$85,000 in 2004 and \$140,000 in 2003)  | 3,373,000    | 4,974,000    |
| Deferred income taxes, current   | 288,000      | 192,000      |
| Other current assets   | 89,000       | 57,000       |
|  | 7,556,000    | 6,721,000    |
| Total current assets   |              |              |
| Furniture, fixtures and equipment, net   | 37,000       | 56,000       |
| Deferred income taxes, non-current   | 12,000       | 53,000       |
| Other assets   | 17,000       | 17,000       |
|  | 7,622,000    | 6,847,000    |
| Total assets   | \$ 7,622,000 | \$ 6,847,000 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |              |              |
| Current liabilities:   |              |              |
| Accounts payable   | \$ 1,366,000 | \$ 1,525,000 |
| Accrued expenses   | 519,000      | 182,000      |
| Income taxes payable   | 54,000       |              |
|  | 1,939,000    | 1,707,000    |
| Total current liabilities  |              |              |
| Long term liabilities:   |              |              |
| Loss on equity investment  | 222,000      | 236,000      |
| Shareholders' equity:  |              |              |
| Preferred stock, no par value; 25,000,000 shares authorized, no shares issued or outstanding                       |              |              |
| Common stock, no par value; 50,000,000 shares authorized; 1,171,169 shares in 2004 and 2003 issued and outstanding | 1,495,000    | 1,495,000    |
| Retained earnings  | 3,966,000    | 3,409,000    |
|  | 5,461,000    | 4,904,000    |
| Total shareholders' equity   |              |              |
| Total liabilities and shareholders' equity   | \$ 7,622,000 | \$ 6,847,000 |

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

**NITCHES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Operations**

|   | Fiscal Year Ended August 31, |           |           |
|---|------------------------------|-----------|-----------|
|   | 2004                         | 2003      | 2002      |
| Net sales   | \$ 32,179                    | \$ 28,440 | \$ 29,589 |
| Cost of goods sold                                | 22,783                       | 21,856    | 22,214    |
|   | 9,396                        | 6,584     | 7,375     |
| Gross profit                                      |                              |           |           |
| Selling, general and administrative               | 8,389                        | 7,663     | 7,132     |
|   | 1,007                        | (1,079)   | 243       |
| Income (loss) from operations                     |                              |           |           |
| Other income                                      |                              | 3         | 16        |
| Interest expense                                  | (93)                         | (83)      | (80)      |
| Gain (loss) from equity investment                | 14                           | (236)     |           |
|   | 928                          | (1,395)   | (179)     |
| Income (loss) before income taxes                 |                              |           |           |
| Provision for (benefit from) income taxes         | 371                          | (425)     | (63)      |
|   | 557                          | (970)     | 116       |
| Net income (loss)                                 | \$ 557                       | \$ (970)  | \$ 116    |
|   |                              |           |           |
| Basic earnings per share                          | \$ .48                       | \$ (0.83) | \$ 0.10   |
| Diluted earnings per share                        | \$ .48                       | \$ (0.83) | \$ 0.10   |
| Weighted average number of common shares (000 s): |                              |           |           |
| Basic   | 1,171                        | 1,171     | 1,112     |
| Diluted   | 1,171                        | 1,171     | 1,112     |
| Number of common shares outstanding at year end   | 1,171                        | 1,171     | 1,171     |

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

**NITCHES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Shareholders' Equity**

|                                 | Common Stock |              | Retained<br>Earnings | Total<br>Shareholders<br>Equity |
|---------------------------------|--------------|--------------|----------------------|---------------------------------|
|                                 | Shares       | Amount       |                      |                                 |
| <b>Balance, August 31, 2001</b> | 1,064,680    | 805,000      | 5,800,000            | 6,605,000                       |
| Net income                      |              |              | 116,000              | 116,000                         |
| Stock dividend                  | 106,489      | 690,000      | (690,000)            |                                 |
| Cash dividends                  |              |              | (495,000)            | (495,000)                       |
| <b>Balance, August 31, 2002</b> | 1,171,169    | \$ 1,495,000 | 4,731,000            | 6,226,000                       |
| Net income                      |              |              | (970,000)            | (970,000)                       |
| Cash dividends                  |              |              | (352,000)            | (352,000)                       |
| <b>Balance, August 31, 2003</b> | 1,171,169    | \$ 1,495,000 | \$ 3,409,000         | \$ 4,904,000                    |
| Net income                      |              |              | 557,000              | 557,000                         |
| Cash dividends                  |              |              |                      |                                 |
| <b>Balance, August 31, 2004</b> | 1,171,169    | \$ 1,495,000 | \$ 3,966,000         | \$ 5,461,000                    |

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



**NITCHES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**

|   | Year ended August 31, |              |             |
|---|-----------------------|--------------|-------------|
|   | 2004                  | 2003         | 2002        |
| <b>Cash flows from operating activities:</b>  |                       |              |             |
| Net income/(loss)   | \$ 557,000            | \$ (970,000) | \$ 116,000  |
| <b>Adjustments to reconcile net income/(loss) to net cash provided by operating activities:</b> |                       |              |             |
| Depreciation and amortization   | 26,000                | 33,000       | 33,000      |
| (Increase) decrease in trade receivables  | (2,661,000)           | 3,519,000    | (1,270,000) |
| (Increase) decrease in due from affiliates & employees  | (4,000)               | 82,000       | (74,000)    |
| (Increase) decrease in income taxes refundable/payable  | 520,000               | (348,000)    | (43,000)    |
| (Increase) decrease in inventories  | 1,601,000             | 332,000      | 102,000     |
| (Increase) decrease in deferred income taxes  | (55,000)              | (79,000)     | 52,000      |
| (Increase) decrease in other current assets   | (32,000)              | 49,000       | 17,000      |
| Increase (decrease) in accounts payable and accrued expenses                                    | 178,000               | (2,570,000)  | 1,593,000   |
| Non-cash (gain) loss from equity investment   | (14,000)              | 236,000      |             |
|   | 116,000               | 284,000      | 526,000     |
| <b>Cash flows from investing activities:</b>  |                       |              |             |
| Purchases of furniture, fixtures and equipment  | (7,000)               | (4,000)      | (41,000)    |
|   | (7,000)               | (4,000)      | (41,000)    |
| <b>Cash flows from financing activities:</b>  |                       |              |             |
| Dividends paid  |                       | (352,000)    | (495,000)   |
|   |                       | (352,000)    | (495,000)   |
| Net increase (decrease) in cash and cash equivalents  | 109,000               | (72,000)     | (10,000)    |
| Cash and cash equivalents at beginning of year  | 110,000               | 182,000      | 192,000     |
|   | \$ 219,000            | \$ 110,000   | \$ 182,000  |
| <b>Supplemental disclosures of cash flow information:</b>                                       |                       |              |             |
| <b>Cash paid during the year:</b>   |                       |              |             |
| Interest  | \$ 93,000             | \$ 83,000    | \$ 80,000   |
|   | \$ 349,000            | \$           | \$ 69,000   |
| <b>Non-cash financing transaction:</b>  |                       |              |             |
| Stock dividend issued   | \$                    | \$           | \$ 690,000  |

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

Nitches Inc, and Subsidiaries  
Notes to the Consolidated Financial Statements

**1. Description of Business**

Nitches, Inc. (the Company) is a wholesale importer and distributor of clothing manufactured to its specifications and distributed in the United States under Company brand labels and retailer-owned private labels. The Company's product lines are women's sleepwear and western wear, men's casual wear and golf apparel, and men's and women's performance apparel.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation:*

The consolidated financial statements include the accounts of Nitches, Inc. and its wholly owned subsidiary, Nitches Far East Limited. All significant inter-company transactions and balances are eliminated in consolidation.

*Financial Instruments:*

Financial instruments consist of cash and cash equivalents, accounts receivable, and accounts payable. The carrying amount approximates fair value because of their short maturity.

*Concentration of Credit Risk:*

The Company sells a majority of its accounts receivable to a financial institution. Under the agreement, the financial institution purchases trade accounts receivable and assumes substantially all credit risks. This agreement is detailed in Note 5. The Company is responsible for following up on adjustments claimed by customers. Accounts that are not sold remain the credit risk of the Company. Such accounts are diverse and are subject to credit approval and ongoing evaluation by the Company. Management considers the credit risk with respect to all receivables to be low. Historically, the Company has not experienced significant loss due to uncollectible accounts receivable.

Cash balances are periodically maintained in amounts in excess of FDIC insured limits in high quality financial institutions. Management considers the risk of loss to be low.

*Inventories:*

Inventories are stated at the lower of cost (first-in, first-out method) or market.

*Furniture, Fixtures and Equipment:*

Furniture, fixtures and equipment are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the related assets, which range from two to ten years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful lives of the assets or the remaining term of the related lease. Maintenance and repair costs are charged to expense as incurred. When assets are retired or sold, the assets and accumulated depreciation are removed from the respective accounts and any profit or loss on the disposition is credited or charged to income.

*Earnings Per Share:*

The computation of net income per common share is based on the weighted average number of common shares outstanding plus common share equivalents arising from dilutive stock options, if any. The weighted average number of common shares and common share equivalents outstanding for basic and diluted earnings per share was 1,171,169 for fiscal 2004 and 2003, and 1,111,944 for fiscal 2002. Earnings per share for all periods prior to 2002 included in these financial statements and footnotes have been restated to give effect to a 10% stock dividend issued March 29, 2002.

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## Nitches Inc, and Subsidiaries Notes to the Consolidated Financial Statements (continued)

### *Revenue Recognition:*

The Company recognizes revenue at the time products are shipped based on its terms of F.O.B. shipping point, where risk of loss and title transfers to the buyer at time of shipment. The Company records sales in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Under these guidelines, revenue is recognized when all of the following exist: persuasive evidence of a sale arrangement exists, delivery of the product has occurred, the price is fixed or determinable and payment is reasonably assured. Provisions are made currently for estimated product returns and sales allowances.

### *Income Taxes:*

The Company records income taxes using an asset and liability method. Under this method, deferred Federal and state income tax assets and liabilities are provided for temporary differences between the financial reporting basis and the tax-reporting basis of the consolidated assets and liabilities. Income taxes are further explained in Note 6.

### *Cash Flow Statement:*

For purposes of the statement of cash flows, the Company considers all highly liquid instruments purchased with a maturity of three months or less to be cash equivalents.

### *Estimates:*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### *Recently issued accounting pronouncements:*

In January 2003, the Financial Accounting Standards Board ( FASB ) issued Interpretation ( FIN ) No. 46, Consolidation of Variable Interest Entities. Until this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 requires a variable interest entity, as defined, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns. FIN No. 46 is effective for reporting periods ending after December 15, 2003. In December 2003, the FASB issued Interpretation 46R (FIN 46R), a revision to FIN 46. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after March 15, 2004. The adoption of this interpretation did not have a significant impact on the Company's financial statements.

In April 2003, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 149 ( SFAS No. 149 ), Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The provisions of this statement will be applied prospectively. This statement amends SFAS 133 for decisions made in the derivatives project implementation process, in connection with other FASB projects dealing with financial instruments, and in connection with implementation issues related to the definition of a derivative. The adoption of SFAS 149 has not had any impact on the financial statements.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ( SFAS No. 150 ), Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This statement requires that certain financial instruments which had previously been classified as equity be classified as liabilities. The Company has no outstanding securities that meet the criteria of SFAS No. 150 and, therefore, this statement will not have any impact on our financial statements.

In March 2004, the FASB issued an exposure draft Share-Based Payment An Amendment of FASB Statements No. 123 and 95. The exposure draft addresses the accounting for transactions in which a company receives employee services in exchange for equity instruments of the company or liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of equity instruments. The Company does not currently have any stock options or similar instruments issued or outstanding, therefore these statements are not expected to have any impact on the Company's financial statements.

**3. Inventories**

|                     | August 31,          |                     |
|---------------------|---------------------|---------------------|
|                     | 2004                | 2003                |
| Fabric and trim     | \$ 141,000          | \$ 335,000          |
| Work in progress    | 1,225,000           | 1,254,000           |
| Finished goods      | 2,092,000           | 3,525,000           |
| Markdown Allowances | (85,000)            | (140,000)           |
|                     | <u>\$ 3,373,000</u> | <u>\$ 4,974,000</u> |

**4. Furniture, Fixtures and Equipment**

|  | August 31,       |                  |
|--|------------------|------------------|
|  | 2004             | 2003             |
| Leasehold improvements                         | \$ 7,000         | \$ 4,000         |
| Computer equipment                             | 27,000           | 27,000           |
| Vehicles                                       | 111,000          | 111,000          |
| Furniture, fixtures and other equipment        | 28,000           | 24,000           |
|  | <u>173,000</u>   | <u>166,000</u>   |
| Less accumulated depreciation and amortization | 136,000          | 110,000          |
|  | <u>\$ 37,000</u> | <u>\$ 56,000</u> |

Nitches Inc, and Subsidiaries  
Notes to the Consolidated Financial Statements (continued)

**5. Trade Accounts Receivable**

Pursuant to the terms of an agreement between Nitches and a factor, Nitches sells a majority of its trade accounts receivable to the factor on a pre-approved, non-recourse basis. The price at which the accounts are sold is the invoice amount reduced by the factor commission (.3% of the invoice amount) and all selling discounts. For accounts sold to the factor without recourse, the factor is responsible for collection, assumes all credit risk, and obtains all of the rights and remedies against the company's customers. For such accounts, payment is due from the factor upon the earlier of the payment of the receivable to the factor by the customer, or the maturity of the receivable (generally 180 days from the date of shipment to the customer). As of August 31, 2004, non-recourse receivables totaled \$5.0 million.

Trade accounts receivable not sold to the factor remain in the custody and control of the Company and the Company maintains all credit risk on those accounts as well as accounts which are sold to the factor with recourse. The combined credit risk for non-factored and recourse receivables as of August 31, 2004, totaled \$958,000.

The Company may request payment from the factor in advance of the collection date or maturity. Any such advance payments are assessed an interest charge through the collection date or maturity at the factor's prime rate less 1.5% (one and one half percent) per annum. The company's obligations with respect to advances from the factor are limited to the interest charges thereon. Advance payments are limited to a maximum of 85% (eighty-five percent) of eligible accounts receivable. The factoring agreement also provides for the issuance of irrevocable letters of credit for the Company's purchase of inventory in the normal course of its business. Letters of credit are subject to a \$6 million limit. All assets of the company collateralize the advances and letters of credit. The Company's Chairman has also provided a personal guaranty in connection with the factoring arrangement.

The status of the Company's trade accounts receivable and letters of credit are as follows:

|   | <b>August 31,</b>   |                     |
|---|---------------------|---------------------|
|   | <b>2004</b>         | <b>2003</b>         |
| <b>Receivables assigned to factor:</b>                          |                     |                     |
| Non-recourse  | \$ 5,028,000        | \$ 2,599,000        |
| Recourse  | 121,000             | 16,000              |
| Advances from factor  | (1,939,000)         | (1,542,000)         |
|   | 3,210,000           | 1,073,000           |
| Due from factor   | 3,210,000           | 1,073,000           |
| Non-factored accounts receivable                                | 837,000             | 370,000             |
| Allowance for customer credits and doubtful accounts            | (492,000)           | (549,000)           |
|   | \$ 3,555,000        | \$ 894,000          |
| <b>Contingent liabilities for irrevocable letters of credit</b> | <b>\$ 2,390,000</b> | <b>\$ 2,401,000</b> |

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Nitches Inc, and Subsidiaries  
Notes to the Consolidated Financial Statements (continued)

6. *Income Taxes*

The components of the provision/(benefit) for income taxes are as follows:

|                  | Year ended August 31, |                     |                  |
|------------------|-----------------------|---------------------|------------------|
|                  | 2004                  | 2003                | 2002             |
| <b>Current:</b>  |                       |                     |                  |
| Federal          | \$ 346,000            | \$ (334,000)        | \$ 2,000         |
| State            | 80,000                | (12,000)            | 9,000            |
|                  | <u>426,000</u>        | <u>(346,000)</u>    | <u>11,000</u>    |
| Deferred         | (55,000)              | (79,000)            | 52,000           |
|                  | <u>371,000</u>        | <u>(425,000)</u>    | <u>63,000</u>    |
| <b>Provision</b> | <b>\$ 371,000</b>     | <b>\$ (425,000)</b> | <b>\$ 63,000</b> |

Net deferred income tax assets at August 31, 2003 and 2002 consist of the tax effects of temporary differences related to the following:

|   | August 31,        |                   |
|---|-------------------|-------------------|
|   | 2004              | 2003              |
| <b>Current deferred assets:</b>             |                   |                   |
| Inventories                                 | \$ 140,000        | \$ 164,000        |
| Sales returns and doubtful account reserves | 144,000           | 94,000            |
| Accrued compensation                        | 42,000            | 12,000            |
| Other items                                 | (38,000)          | (78,000)          |
|   | <u>\$ 288,000</u> | <u>\$ 192,000</u> |

|                                     | August 31,       |                  |
|-------------------------------------|------------------|------------------|
|                                     | 2004             | 2003             |
| <b>Non-current deferred assets:</b> |                  |                  |
| Fixed assets                        | \$ 12,000        | \$ 10,000        |
| State tax NOL                       |                  | 43,000           |
|                                     | <u>\$ 12,000</u> | <u>\$ 53,000</u> |

Differences between the statutory Federal income tax rate and the effective tax rate as a percentage of pre-tax income are as follows:

|  | Year ended August 31, |         |       |
|--|-----------------------|---------|-------|
|  | 2004                  | 2003    | 2002  |
| Statutory rate                             | 34.0%                 | (34.0)% | 34.0% |
| State income taxes, net of Federal benefit | 5.8%                  | (5.8)%  | 5.8%  |
| State NOL limitation                       | 0.0%                  | 2.0%    |       |

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|                                      |                   |                   |                   |
|--------------------------------------|-------------------|-------------------|-------------------|
| (Gain)/loss on equity investment     | (0.5)%            | 6.7%              |                   |
| Nondeductible entertainment expenses | 0.2%              | 0.0%              | 0.0%              |
| Other items                          | 0.5%              | 0.6%              | (4.6)%            |
|                                      | <u>          </u> | <u>          </u> | <u>          </u> |
| Effective rate                       | 40.0%             | (30.5)%           | 35.2%             |
|                                      | <u>          </u> | <u>          </u> | <u>          </u> |

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## Nitches Inc, and Subsidiaries Notes to the Consolidated Financial Statements (continued)

### 7. Employee Benefit Plans

The Company has a 401(k) Savings Plan, whereby employees may make investments in various independent funds and Company stock. The Company may match employee contributions to this Plan on a discretionary basis or contribute on a profit sharing basis. The Company made no matching or profit sharing contributions to this Plan in fiscal 2004, 2003, or 2002.

### 8. Stock Options and Dividends

#### Stock Options

No stock options were outstanding as of August 31, 2004, 2003 or 2002. The Company does not have an active stock option plan.

#### Dividends

During fiscal 2004 the Company did not declare a dividend. However, during fiscal 2003 the company declared and paid cash dividends of \$0.30 per share. During fiscal 2002, the company declared and paid cash dividends of \$0.45 per share. Separately, on March 29, 2002 the Company issued a 10% stock dividend, or 106,489 shares, to holders of record as of March 22, 2002. Earnings per share for all periods prior to 2002 included in these financial statements and footnotes have been restated to give effect to this dividend.

### 9. Leases

The Company has lease commitments expiring at various dates through September 2006, principally for real property and equipment. The aggregate minimum rental commitments for future years ending August 31 for all non-cancelable leases having initial or remaining terms of one or more years are as follows:

|              |                   |
|--------------|-------------------|
| <b>2005</b>  | 363,000           |
| <b>2006</b>  | 285,000           |
| <b>2007</b>  | 6,000             |
|              | <hr/>             |
| <b>Total</b> | <b>\$ 654,000</b> |

The Company's leases for real property are generally subject to rent escalation based on increases in the consumer price or other indices with certain minimum and maximum increases. Rent expense, net of sublease income, was approximately \$391,000, \$396,000, and \$418,000, during fiscal 2004, 2003 and 2002, respectively.

### 10. Operating Segments and Major Customers

The Company's products comprise a single operating segment. No significant assets are maintained outside the United States. Sales are made to a variety of customers throughout the United States. Sales to Wal-Mart (Sam's Club) and Kohl's accounted for 32.3% and 31.2%, respectively, of the Company's net sales in fiscal 2004. Kohl's, Mervyn's, and Sears accounted for 29.2%, 16.9% and 6.5%, respectively, of the Company's net sales in fiscal 2003.

Wal-Mart and Kohl's, accounted for 44.0% and 41.5%, respectively, of the Company's trade receivable balance at August 31, 2004. Kohl's accounted for 33.7% of the Company's trade receivable balance at August 31, 2003.

### 11. Equity Investment

In October 2002, the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC which was later assumed by CIT, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guaranty formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. In the event of a call on this guaranty by CIT, Nitches has a contract with the remaining shareholders of Designer Intimates to limit Nitches' exposure to 28% of the called value, subject to the maximum guaranty of \$3.0 million.



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Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For fiscal year ended August 31, 2004, the Company recognized a gain of \$14,000 from the unconsolidated subsidiary. This gain is non-cash income and is not taxable to the Company. For that same period in fiscal 2004, Designer Intimates earned \$49,000 on sales of \$68.3 million. Cumulative losses on this investment of \$222,000 and \$236,000 are shown as a liability on the consolidated balance sheet as of August 31, 2004 and 2003, respectively.

Nitches has introduced Designer Intimates to the factories that Nitches uses for its own sleepwear product line. This provides access to a lower cost production base than Designer Intimates has had in Turkey where it has historically produced over ninety percent of its products which are predominantly robes and lounge wear. In an agreement with Designer Intimates, Nitches has produced a line of sleepwear under the Dockers label. This product contributed approximately \$1.4 million dollars of sales for Nitches in fiscal year 2004. As of August 31, 2004, Nitches had a backlog of approximately \$1.8 million for this product line.

Nitches Inc, and Subsidiaries  
Notes to the Consolidated Financial Statements (continued)

The unaudited condensed financial statements of the Company's equity method affiliate are summarized below:

**Designer Intimates, Inc.**  
**Consolidated Statement of Revenue and Expenses**

|  | <b>Fiscal year ended<br/>August 31, 2004</b> | <b>11 months ended<br/>August 31, 2003</b> |
|--|--|--|
| Net Sales                                    | \$ 68,278,000                                | \$ 69,218,000                              |
| Cost of sales                                | 53,464,000                                   | 54,932,000                                 |
| Gross profit                                 | 14,814,000                                   | 14,286,000                                 |
| Selling, general and administrative expenses | 14,452,000                                   | 14,681,000                                 |
| Income/(loss) from operations                | 362,000                                      | (395,000)                                  |
| Interest expense                             | 236,000                                      | 277,000                                    |
| Other income                                 | (123,000)                                    |  |
| Income/(loss) before income taxes            | 249,000                                      | (672,000)                                  |
| Provision for income taxes                   | 200,000                                      | 170,000                                    |
| Net income/(loss)                            | \$ 49,000                                    | \$ (842,000)                               |

Nitches Inc, and Subsidiaries  
Notes to the Consolidated Financial Statements (continued)

11. *Equity Investment, continued*

**Designer Intimates, Inc.  
Consolidated Balance Sheet**

|  | August 31    |               |
|--|--------------|---------------|
|  | 2004         | 2003          |
| <b>ASSETS</b>  |              |               |
| Current assets:  |              |               |
| Cash   | \$ 120,000   | \$ 132,000    |
| Accounts receivable - trade, less allowances                             |              | 411,000       |
| Inventories  | 5,301,000    | 8,738,000     |
| Prepaid expenses and other current assets                                | 87,000       | 37,000        |
| Income taxes receivable  |              | 423,000       |
| Deferred income taxes, current   | 125,000      | 200,000       |
|  | 5,633,000    | 9,941,000     |
| Fixed assets:  |              |               |
| Furniture, Fixtures and equipment  | 637,000      | 604,000       |
| Leasehold improvements   | 570,000      | 555,000       |
| Less: Accumulated depreciation and amortization                          | (556,000)    | (257,000)     |
|  | 651,000      | 902,000       |
| Other assets:  |              |               |
| Goodwill   | 2,548,000    | 2,548,000     |
| Other intangible assets subject to amortization                          | 201,000      | 387,000       |
| Deferred income taxes, non-current                                       | 75,000       |               |
| Other assets   | 100,000      | 95,000        |
|  | 2,924,000    | 3,030,000     |
| Total other assets   | \$ 9,208,000 | \$ 13,873,000 |
|  | 9,208,000    | 13,873,000    |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                               |              |               |
| Current liabilities:   |              |               |
| Loans payable - banks  | \$           | \$ 3,199,000  |
| Due to factor  | 317,000      |               |
| Accounts payable   | 8,561,000    | 10,544,000    |
| Income taxes payable   | 350,000      |               |
| Accrued expenses and other current liabilities                           | 770,000      | 969,000       |
|  | 9,998,000    | 14,712,000    |
| Shareholders Deficit:  |              |               |
| Common stock, 1,000 shares authorized, 300 shares issued and outstanding | 3,000        | 3,000         |
| Deficit (beginning October 1, 2002)                                      | (793,000)    | (842,000)     |
|  | (790,000)    | (839,000)     |
| Total shareholders deficit   | \$ 9,208,000 | \$ 13,873,000 |
|  | 9,208,000    | 13,873,000    |

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Nitches Inc, and Subsidiaries  
Notes to be Consolidated Financial Statements (contintued)

12. *Quarterly Results of Operations (Unaudited)*

The following is a summary of the quarterly results of operations for the years ended August 31, 2004 and 2003.

|                                    | <b>Three months ended</b>                       |                    |               |                  |
|------------------------------------|---|--------------------|---------------|------------------|
|                                    | <b>November 30</b>                              | <b>February 28</b> | <b>May 31</b> | <b>August 31</b> |
|                                    | <b>(In thousands, except per share amounts)</b> |                    |               |                  |
| <b>Fiscal 2004</b>                 |   |                    |               |                  |
| Net sales                          | \$ 6,796  | \$ 9,683           | \$ 9,024      | \$ 6,676         |
| Gross profit                       | 1,731   | 3,060              | 2,719         | 1,886            |
| Net income (loss)                  | 488   | 285                | 83            | (299)            |
| Net income (loss) per common share | \$ 0.42   | \$ 0.24            | \$ 0.07       | \$ (0.25)        |
| <b>Fiscal 2003</b>                 |   |                    |               |                  |
| Net sales                          | \$ 10,435                                       | \$ 6,699           | \$ 7,028      | \$ 4,278         |
| Gross profit                       | 1,935   | 1,741              | 2,144         | 1,312            |
| Net income (loss)                  | 460   | (155)              | (84)          | (1,191)          |
| Net income (loss) per common share | \$ 0.39   | \$ (0.13)          | \$ (0.07)     | \$ (1.02)        |

**Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**PART III**

**Item 10 - Directors and Executive Officers of the Registrant**

The information required as to this Item is incorporated herein by reference from the data under the caption Information Concerning Nominees, Directors and Executive Officers in the Proxy Statement ( 2004 Proxy Statement ) to be used in connection with the solicitation of proxies to be voted at the Registrant's annual meeting of shareholders to be held in March 2005, to be filed with the Commission in February 2005.

**Item 11 - Executive Compensation**

The information required as to this Item is incorporated herein by reference from the data under the captions Executive Officer Compensation , Board Compensation Committee Report on Executive Compensation and Employment Agreements in the 2004 Proxy Statement.

**Item 12 - Security Ownership of Certain Beneficial Owners and Management**

The information required as to this Item is incorporated herein by reference from the data under the caption Principal Shareholders in the 2004 Proxy Statement.

**Item 13 - Certain Relationships and Related Transactions**

The information required as to this Item is incorporated herein by reference from the data under the caption Certain Relationships and Related Transactions in the 2004 Proxy Statement.

**Item 14 - Controls and Procedures**

In October 2004, our management concluded that there were certain material weaknesses in our internal controls and procedures. The material weaknesses noted related to segregation of duties in the payroll process and in the monthly closing process; inadequate review and approval of management-level adjustments and entries. We have discussed these material weaknesses with our auditors, Moss Adams, LLP, who have recommended taking steps to alleviate the inadequate segregation of duties within these areas.

The Company and our Audit Committee are committed to remediating the material weaknesses. We plan to implement appropriate mitigating factors in order to reduce the likelihood of material misstatements or improper disclosure.

During the period beginning in October 2004, we began to implement steps to address our internal controls and procedures. The following remediation actions have been completed:

We began requiring the Accounting Manager to review, approve and maintain back-up for all accounting entries. We began requiring the President to then document his review of the adequacy and completeness of the closing process.

We began requiring the Audit Committee to review and approve all officer expense reimbursements.

We are in the process of developing and implementing the following remediation steps. We expect to be able to fully implement these actions by the end of the second quarter 2005.

We are in a search for a Controller.

We are evaluating the effectiveness of our current control structure.

We will place the payroll duties with the Controller, when hired.

We will remove the payroll clerk, who is a related party, from the authorized check signer list.

Within 90 days prior to the date of this report, the Chief Executive and Financial Officer evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, he concluded that the disclosure controls and procedures of the Company are effective in timely alerting of the material information required to be included in the periodic filings with the Securities and Exchange Commission and that the information required to be disclosed in these filings is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Commission.



**PART IV**

**Item 15 - Exhibits, Financial Statement Schedules and Reports on Form 8-K**

(a) Documents filed as part of this report:

1. The following consolidated financial statements of the Registrant are included as part of this report:

Consolidated Balance Sheets as of August 31, 2004 and 2003;

Consolidated Statements of Income for the years ended August 31, 2004, 2003 and 2002;

Consolidated Statements of Shareholders' Equity for the years ended August 31, 2004, 2003 and 2002;

Consolidated Statements of Cash Flows for the years ended August 31, 2004, 2003 and 2002;

Notes to Consolidated Financial Statements; and Independent Auditor Report

2. The following financial statement schedules of the Registrant are included as part of this report:

Report of independent auditors on Schedule II

Schedule II - Valuation and Qualifying Accounts and Reserves

All other schedules are omitted because they are not required, are inapplicable or the information is otherwise shown in the financial statements or notes thereto.

3. The following exhibits are filed herewith or incorporated by reference as indicated. Exhibit numbers refer to Item 601 of Regulation S-K:

3.1 Articles of Incorporation of the Company, as amended (1)

3.2 Bylaws of the Company, as amended (2)

10.1 Form of Indemnification Agreement for Officers and Directors (1)

10.2 Asset Purchase Agreement and related agreements between the Company and Design and Source Holding Company, Ltd. effective July 1, 1995 (3)

10.3 Employment agreement dated September 1, 2001 between the Company and Steven Wyandt (4)

(b) Exhibits and Reports on Form 8-K. None

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**Footnotes**

(1) Incorporated by reference from Registrant's Form 10-K filed on November 23, 1992 for the fiscal year ended August 31, 1992.

(2) Incorporated by reference from Registrant's Form 10-K filed on November 23, 1988 for the fiscal year ended August 31, 1988.

(3) Incorporated by reference from Registrant's Form 10-K filed on November 3, 1995 for the fiscal year ended August 31, 1995.

(4) Incorporated by reference in Schedule 13E-4 filed with the SEC on August 18, 1998 and amendments related thereto.

**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, there unto duly authorized.

Date: December 20, 2004

**NITCHES, I NC.**

By:                                   /s/ STEVEN P. WYANDT                                  

**Steven P. Wyandt, Chairman**

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.

|                                   |   |                          |
|-----------------------------------|---|--------------------------|
| <p>/s/ STEVEN P. WYANDT</p> <hr/> | <p>Chief Executive Officer<br/>                 (Principal Executive Officer), Chief<br/>                 Financial Officer (Principal Financial<br/>                 Officer) and Director</p> | <p>December 20, 2004</p> |
|-----------------------------------|---|--------------------------|

**Steven P. Wyandt**

|                                 |   |                          |
|---------------------------------|---|--------------------------|
| <p>/s/ PAUL M. WYANDT</p> <hr/> | <p>President, Chief Operating Officer<br/>                 (Principal Operating Officer), and<br/>                 Director</p> | <p>December 20, 2004</p> |
|---------------------------------|---|--------------------------|

**Paul M. Wyandt**

|                                     |                 |                          |
|-------------------------------------|-----------------|--------------------------|
| <p>/s/ EUGENE B. PRICE II</p> <hr/> | <p>Director</p> | <p>December 20, 2004</p> |
|-------------------------------------|-----------------|--------------------------|

**Eugene B. Price II**

|                                   |                 |                          |
|-----------------------------------|-----------------|--------------------------|
| <p>/s/ WILLIAM L. HOESE</p> <hr/> | <p>Director</p> | <p>December 20, 2004</p> |
|-----------------------------------|-----------------|--------------------------|

**William L. Hoese**

|                                  |                 |                          |
|----------------------------------|-----------------|--------------------------|
| <p>/s/ ALLAN R. BAILEY</p> <hr/> | <p>Director</p> | <p>December 20, 2004</p> |
|----------------------------------|-----------------|--------------------------|

**Allan R. Bailey**



**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders  
Nitches, Inc. and Subsidiaries  
San Diego, California

Our audit of the consolidated financial statements of Nitches, Inc. and Subsidiaries referred to in our report dated October 22, 2004 appearing in item 8 in this Annual Report of Form 10-K also included an audit of the information included in the financial statement schedule listed in item 14(a) of this Form 10-K. In our opinion, the information included in the financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

MOSS ADAMS LLP

Los Angeles, California  
October 22, 2004

## NITCHES, INC.

## Valuation and Qualifying Accounts and Reserves

|   | Balance at<br>Beginning<br>of Year | Additions                           |                                 | Deductions | Balance at<br>End of Year |
|---|------------------------------------|-------------------------------------|---------------------------------|------------|---------------------------|
|   |                                    | Charged to<br>Costs and<br>Expenses | Charged to<br>Other<br>Accounts |            |                           |
| Year ended August 31, 2002                      |                                    |                                     |                                 |            |                           |
| Allowance for doubtful accounts & sales returns | \$ 196,000                         | \$ 41,000                           |                                 |            | \$ 237,000                |
| Inventory markdown allowance                    | \$ 102,000                         |                                     |                                 | \$ 27,000  | \$ 75,000                 |
| Year ended August 31, 2003                      |                                    |                                     |                                 |            |                           |
| Allowance for doubtful accounts & sales returns | \$ 237,000                         | \$ 663,000                          |                                 | \$ 351,000 | \$ 549,000                |
| Inventory markdown allowance                    | \$ 75,000                          | \$ 324,000                          |                                 | \$ 259,000 | \$ 140,000                |
| Year ended August 31, 2004                      |                                    |                                     |                                 |            |                           |
| Allowance for doubtful accounts & sales returns | \$ 549,000                         | \$ 330,000                          |                                 | \$ 387,000 | \$ 492,000                |
| Inventory markdown allowance                    | \$ 140,000                         | \$ 118,000                          |                                 | \$ 173,000 | \$ 85,000                 |

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Exhibit</b>  |
|---------------------------|---|
| *3.1                      | Articles of Incorporation of the Company, as amended  |
| *3.2                      | Bylaws of the Company, as amended   |
| *10.1                     | Form of Indemnification Agreement for Officers and Directors  |
| *10.2                     | Asset Purchase Agreement and related agreements between the Company and Design and Source Holding Company, Ltd effective July 1, 1995 |
| *10.3                     | Employment Agreement dated September 1, 2001 between the Company and Steven P. Wyandt   |
| 31                        | Certification required under Section 302  |
| 32                        | Certification required under Section 906  |

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\* Incorporated by reference; see page 26.