

INNOVO GROUP INC
Form 10-Q
October 05, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended August 26, 2006

OR

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

For the transition period from _____ to _____

Commission File Number: 0-18926

INNOVO GROUP INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

11-2928178

(I.R.S. Employer Identification No.)

5901 South Eastern Avenue, Commerce, California

(Address of principal executive offices)

90040

(Zip Code)

(323) 837-3700

(Registrant's telephone number, including area code)

5804 East Slauson Avenue, Commerce, California 90040

(Former name, former address and former fiscal year, if changed since last report)

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

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

(Check One):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes No

The number of shares of the registrant's common stock outstanding as of October 4, 2006 was 34,343,454.

INNOVO GROUP INC.

QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

INNOVO GROUP INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	08/26/06 (unaudited)	11/26/05
ASSETS		
Current assets		
Cash and cash equivalents	\$ 226	\$ 560
Accounts receivable, net of allowance for customer credits and returns of \$1,515 (2006) and \$412 (2005)	793	60
Inventories, net	8,152	12,083
Due from related parties, net		2,781
Prepaid expenses and other current assets	382	96
Assets of discontinued operations	112	11,233
Total current assets	9,665	26,813
Property and equipment, net	855	428
Goodwill	20	20
Intangible assets, net	212	248
Other assets	134	87
Total assets	\$ 10,886	\$ 27,596
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable and accrued expenses	\$ 5,607	\$ 3,859
Due to factor		2,855
Due to related parties, net	1,777	54
Liabilities of discontinued operations	98	9,271
Total current liabilities	7,482	16,039
Commitments and contingencies		
Stockholders' equity		
Preferred stock, \$0.10 par value: 5,000 shares authorized, no shares issued or outstanding		
Common stock, \$0.10 par value: 80,000 shares authorized 34,455 shares issued and 34,343 outstanding (2006) and 33,414 shares issued and 33,302 outstanding (2005)	3,447	3,343
Additional paid-in capital	79,760	78,823
Accumulated deficit	(77,027)	(67,833)
Treasury stock, 112 shares	(2,776)	(2,776)
Total stockholders' equity	3,404	11,557
Total liabilities and stockholders' equity	\$ 10,886	\$ 27,596

The accompanying notes are an integral part of these financial statements

INNOVO GROUP INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Three months ended		Nine months ended	
	08/26/06	08/27/05	08/26/06	08/27/05
	(unaudited)		(unaudited)	
Net sales	\$ 12,448	\$ 12,600	\$ 32,662	\$ 28,424
Cost of goods sold	7,485	7,830	22,648	16,901
Gross profit	4,963	4,770	10,014	11,523
Operating expenses				
Selling, general and administrative	5,168	5,166	16,396	13,657
Depreciation and amortization	78	53	200	125
	5,246	5,219	16,596	13,782
Loss from continuing operations	(283)	(449)	(6,582)	(2,259)
Interest expense	(133)	(140)	(378)	(634)
Other income (expense)			(68)	7)
Loss from continuing operations, before taxes	(416)	(589)	(7,028)	(2,886)
Income taxes	13	3	28	21
Loss from continuing operations	(429)	(592)	(7,056)	(2,907)
Income (loss) from discontinued operations, net of tax	(95)	2,007	(2,138)	4,209
Net income (loss)	\$ (524)	\$ 1,415	\$ (9,194)	\$ 1,302
Earnings (loss) per common share - Basic				
Earnings (loss) from continuing operations	\$ (0.01)	\$ (0.02)	\$ (0.21)	\$ (0.09)
Earnings (loss) from discontinued operations	0.00	0.06	(0.06)	0.13
Earnings (loss) per common share - Basic	\$ (0.01)	\$ 0.04	\$ (0.27)	\$ 0.04
Earnings (loss) per common share - Diluted				
Earnings (loss) from continuing operations	\$ (0.01)	\$ (0.02)	\$ (0.21)	\$ (0.09)
Earnings (loss) from discontinued operations	0.00	0.06	(0.06)	0.13
Earnings (loss) per common share - Diluted	\$ (0.01)	\$ 0.04	\$ (0.27)	\$ 0.04
Weighted average shares outstanding				
Basic	34,343	33,286	33,691	31,489
Diluted	34,343	33,286	33,691	31,489

The accompanying notes are an integral part of these financial statements

INNOVO GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine months ended	
	08/26/06	08/27/05
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash provided by (used in) continuing activities	\$ 3,187	\$ (2,976)
Cash provided by (used in) discontinued operations	574	(5)
Net cash provided by (used in) operating activities	3,761	(2,981)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(612)	(331)
Cash used in continuing activities	(612)	(331)
Cash provided by (used in) discontinued operations	614	(26)
Net cash provided by (used in) investing activities	2	(357)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from (payments on) factor borrowing, net	(2,855)	885
Payments on note payable officer		(439)
Proceeds from promissory note - former officer		703
Exercise of stock options		567
Exercise of warrants		2,284
Payment of stock issuance expense		(6)
Net cash (used in) provided by continuing activities	(2,855)	3,994
Cash used in discontinued operations	(1,242)	(201)
Net cash (used in) provided by financing activities	(4,097)	3,793
NET CHANGE IN CASH AND CASH EQUIVALENTS	(334)	455
CASH AND CASH EQUIVALENTS, at beginning of period	560	312
CASH AND CASH EQUIVALENTS, at end of period	\$ 226	\$ 767

The accompanying notes are an integral part of these financial statements

INNOVO GROUP INC AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(in thousands)

	Preferred Stock Shares	Par Value	Common Stock Shares	Par Value	Additional Paid-In Capital	Accumulated Deficit	Promissory Note - former Officer	Treasury Stock	Total Stockholders Equity
Balance, November 27, 2004	194	\$	29,266	\$ 2,927	\$ 72,043	\$ (51,400)	\$ (703)	\$ (2,588)	\$ 20,279
Net loss						1,302			1,302
Payment of promissory note - former officer							703		703
Redemption of preferred stock	(194)								
Conversion of Convertible notes to common stock			2,560	256	4,129				4,385
Common stock registration related expense					(6)				(6)
Exercise of stock options			623	63	470			(188)	345
Exercise of warrants			965	97	2,187				2,284
Balance, August 27, 2005 (unaudited)		\$	33,414	\$ 3,343	\$ 78,823	\$ (50,098)		\$ (2,776)	\$ 29,292
Balance, November 26, 2005 (unaudited)		\$	33,414	\$ 3,343	\$ 78,823	\$ (67,833)		\$ (2,776)	\$ 11,557
Net loss						(9,194)			(9,194)
Common stock issued to related party			1,041	104	(104)				
Stock-based compensation					1,041				1,041
Balance, August 26, 2006 (unaudited)		\$	34,455	\$ 3,447	\$ 79,760	\$ (77,027)		\$ (2,776)	\$ 3,404

The accompanying notes are an integral part of these financial statements

INNOVO GROUP INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

The unaudited condensed consolidated financial statements of Innovo Group, Inc., or Innovo Group, which include the accounts of its wholly-owned subsidiaries, for the three and nine months ended August 26, 2006 and August 27, 2005 and the related footnote information have been prepared on a basis consistent with Innovo Group's audited consolidated financial statements as of November 26, 2005 contained in Innovo Group's Annual Report on Form 10-K for the year ended November 26, 2005, or the Annual Report. Innovo Group's operating subsidiaries include the following entities: Joe's Jeans Inc., or Joe's, and Innovo Azteca Apparel, Inc., or IAA. All significant inter-company transactions have been eliminated. Currently, Innovo Group has only one segment of operations - apparel. Historically, Innovo Group operated in two segments - apparel and accessories.

As a result of the sale of assets related to certain areas of its operations, Innovo Group has reclassified and reported the following operating divisions of its various subsidiaries as Discontinued Operations : (1) its craft and accessories division operated under its Innovo Inc. subsidiary, or Innovo, sold in May 2005; (2) its former headquarters in Springfield, Tennessee that was used as a commercial rental property operated under its Leaseall Management Inc. subsidiary, or Leaseall, sold in February 2006; and (3) its private label apparel division operated by its IAA subsidiary and sold in May 2006. Continuing operations include the results of Innovo Group's branded apparel business, including certain terminated branded apparel lines, which were not separate operating divisions and thus, not considered to be part of Innovo Group's Discontinued Operations.

These unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the related notes thereto contained in Innovo Group's Annual Report. In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting of normal recurring adjustments), which management considers necessary to present fairly Innovo Group's financial position, results of operations and cash flows for the interim periods presented. The results for the three and nine months ended August 26, 2006 are not necessarily indicative of the results anticipated for the entire year ending November 25, 2006.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results may differ from those estimates.

NOTE 2 INVENTORIES

Inventories are stated at the lower of cost, as determined by the first-in, first-out method, or market. Inventories consisted of the following (in thousands):

	08/26/06	11/26/05
Finished goods	\$ 4,904	\$ 10,396
Work in progress	2,077	1,381
Raw materials	2,328	4,015
	9,309	15,792
Less allowance for obsolescence and slow moving items	(1,157)	(3,709)
	\$ 8,152	\$ 12,083

NOTE 3 SALE OF CERTAIN ASSETS OF PRIVATE LABEL APPAREL DIVISION

On March 31, 2006, Innovo Group and its IAA subsidiary entered into an Asset Purchase Agreement, or Cygne APA, with Cygne Designs, Inc., or Cygne. Pursuant to the Cygne APA, Innovo Group agreed to sell to Cygne certain assets related to its private label apparel division. These assets include the private label division's customer list, the assumption of certain existing purchase orders and inventory related to the private label division, and the assumption of the benefit of a non-compete clause in favor of Azteca Production International, Inc., or Azteca, entered into under the original asset purchase agreement between IAA and Azteca. In exchange for the purchased assets, Cygne agreed to assume certain liabilities associated with the private label division, including, the remaining obligation under the original promissory note executed in favor of Azteca under the original asset purchase agreement (and as more fully described in Note 4 Related Party Transactions), certain other liabilities owed in connection with the private label division to Azteca in excess of \$1,500,000, certain liabilities associated with outstanding purchase orders and inventory schedules listed in the Cygne APA, the obligation to continue to pay the earn-out under the original asset purchase agreement and the assumption of the liabilities related to the workforce of the private label division. The aggregate value of the assumed liabilities which represented the purchase price for the transaction at the time of execution of the Cygne APA was estimated to be \$10,437,000, subject to certain permitted adjustments on the closing date. On May 12, 2006, Innovo Group conducted its annual meeting of stockholders and its stockholders approved the sale of its private label apparel division pursuant to the Cygne APA. Immediately thereafter, Innovo Group and Cygne closed the transaction. No cash was transferred at closing and each party was responsible for its respective transaction costs. Innovo Group recorded an approximate charge of \$36,000 for certain property and equipment disposed of or abandoned as part of discontinuing these operations.

The following table sets forth a summary of the assumption of the liabilities less the net book value of the assets and Innovo Group's resulting loss on the sale of these assets (in thousands):

Note payable - related party	\$ 7,937
Other related party liabilities	2,500
Total purchase price (Liabilities assumed by buyer)	10,437
