

OVERSTOCK.COM, INC
Form 10-Q
May 09, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

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: 000-49799

OVERSTOCK.COM, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

87-0634302

(I.R.S. Employer
Identification Number)

6350 South 3000 East

Salt Lake City, Utah 84121

(Address, including zip code, of

Registrant's principal executive offices)

Registrant's telephone number, including area code: **(801) 947-3100**

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), (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 (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

There were 23,683,531 shares of the Registrant's common stock, par value \$0.0001, outstanding on May 8, 2007.

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Overstock.com, Inc.

Consolidated Balance Sheets (unaudited)

(in thousands)

	December 31, 2006	March 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 126,965	\$ 68,080
Accounts receivable, net	11,638	7,811
Note receivable	6,702	2,761
Inventories, net	20,274	16,662
Prepaid inventory	2,241	2,601
Prepaid expense	7,473	9,435
Current assets of held for sale subsidiary	4,718	2,148
Total current assets	180,011	109,498
Property and equipment, net	56,198	48,909
Goodwill	2,784	2,784
Other long-term assets, net	578	483
Long-term assets of held for sale subsidiary	16,594	12,805
Total assets	\$ 256,165	\$ 174,479
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 66,039	\$ 27,936
Accrued liabilities	40,142	22,976
Capital lease obligations, current	5,074	3,810
Current liabilities of held for sale subsidiary	3,684	993
Total current liabilities	114,939	55,715
Capital lease obligations, non-current	3,983	
Convertible senior notes	75,279	75,365
Total liabilities	194,201	131,080
Commitments and contingencies (Notes 12 and 13)		
Stockholders equity:		
Preferred stock, \$0.0001 par value, 5,000 shares authorized, no shares issued and outstanding as of December 31, 2006 and March 31, 2007		
Common stock, \$0.0001 par value, 100,000 shares authorized, 25,069 and 25,258 shares issued as of December 31, 2006 and March 31, 2007, respectively	2	2
Additional paid-in capital	325,771	327,399
Accumulated deficit	(198,694)	(220,077)
Treasury stock, 1,654 and 1,620 shares at cost as of December 31, 2006 and March 31, 2007, respectively	(64,983)	(63,778)
Accumulated other comprehensive loss	(132)	(147)
Total stockholders equity	61,964	43,399
Total liabilities and stockholders equity	\$ 256,165	\$ 174,479

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

Overstock.com, Inc.

Consolidated Statements of Operations (unaudited)

(in thousands, except per share data)

	Three months ended March 31,	
	2006	2007
Revenue		
Direct	\$ 79,710	\$ 45,701
Fulfillment partner	98,334	112,229
Total revenue	178,044	157,930
Cost of goods sold:		
Direct(1)	70,703	39,320
Fulfillment partner	83,587	93,295
Total cost of goods sold	154,290	132,615
Gross profit	23,754	25,315
Operating expenses:		
Sales and marketing(1)	12,659	11,284
Technology(1)	13,424	14,973
General and administrative(1)	11,850	10,689
Restructuring		6,089
Total operating expenses	37,933	43,035
Operating loss	(14,179)	(17,720)
Interest income	315	990
Interest expense	(1,267)	(1,029)
Loss from continuing operations	(15,131)	(17,759)
Loss from discontinued operations	(779)	(3,624)
Net loss	(15,910)	(21,383)
Deemed dividend related to redeemable common shares	(33)	
Net loss attributable to common shares	\$ (15,943)	\$ (21,383)
Net loss per common share basic and diluted:		
Loss from continuing operations	\$ (0.78)	\$ (0.75)
Loss from discontinued operations	\$ (0.04)	\$ (0.16)
Net loss per common share basic and diluted	\$ (0.82)	\$ (0.91)
Weighted average common shares outstanding basic and diluted	19,385	23,594

(1) Includes stock-based compensation from options as follows:

Cost of goods sold direct	\$96	\$107
Sales and marketing	\$70	\$78
Technology	\$159	\$177
General and administrative	\$633	\$711

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

Overstock.com, Inc.

Consolidated Statements of Stockholders' Equity

and Comprehensive Loss (unaudited)

(in thousands)

	Common stock		Additional	Accumulated	Treasury stock		Accumulated	Other	Total
	Shares	Amount	Paid-in	Deficit	Shares	Amount	Loss	Comprehensive	
Balance at December 31, 2006	25,069	\$ 2	\$ 325,771	\$ (198,694)	(1,654)	\$ (64,983)	\$ (132)		\$ 61,964
Exercise of stock options	189		1,153						1,153
Treasury stock issued to employees as compensation			(603)		38	1,205			602
Stock-based compensation from employee options			1,073						1,073
Stock-based compensation to consultants in exchange for services			5						5
Comprehensive loss:									
Net loss				(21,383)					(21,383)
Cumulative translation adjustment							(15)		(15)
Total comprehensive loss									(21,398)
Balance at March 31, 2007	25,258	\$ 2	\$ 327,399	\$ (220,077)	(1,616)	\$ (63,778)	\$ (147)		\$ 43,399

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

Overstock.com, Inc.

Consolidated Statements of Cash Flows (unaudited)

(in thousands)

	Three months ended March 31,		Twelve months ended March 31,	
	2006	2007	2006	2007
Cash flows from operating activities of continuing operations:				
Net loss	\$ (15,910)	\$ (21,383)	\$ (36,518)	\$ (107,239)
Adjustments to reconcile net loss to net cash used in operating activities of continuing operations:				
Loss from discontinued operations	779	3,624	3,350	9,727
Depreciation and amortization	6,150	7,771	18,626	33,948
Realized (gain) loss from marketable securities	(217)		3,135	(1,868)
Loss on disposition of property and equipment	598		2,055	1
Stock-based compensation	958	1,073	1,010	4,235
Stock-based compensation to consultants for services	43	5	54	(15)
Treasury stock issued to employees as compensation	507	602	699	882
Amortization of debt discount and deferred financing fees	139	86	452	364
Restructuring		6,089		11,763
Gain from retirement of convertible senior notes			(6,158)	
Changes in operating assets and liabilities, net of effect of acquisition and discontinued operations:				
Accounts receivable, net	2,316	3,827	(1,238)	(541)
Inventories, net	11,918	3,612	(31,223)	58,703
Prepaid inventory	794	(360)	1,068	6,234
Prepaid expenses	(1,894)	(1,962)	(614)	936
Other long-term assets, net	47	90	(1,490)	539
Accounts payable	(63,621)	(38,059)	(4,211)	(9,638)
Accrued liabilities	(15,185)	(23,255)	7,537	(19,986)
Net cash used in operating activities of continuing operations	(72,578)	(58,240)	(43,466)	(11,955)
Cash flows from investing activities of continuing operations:				
Change in restricted cash	198		957	55
Purchases of marketable securities	(100)		(59,699)	
Sales of marketable securities	7,281		164,284	49,475
Expenditures for property and equipment	(6,804)	(477)	(38,416)	(17,114)
Proceeds from sale of property and equipment				1
Acquisition of Ski West			(25,111)	
Decrease in cash resulting from deconsolidation of variable interest entity				(102)
Payments received on note receivable		3,941		3,941
Net cash provided by investing activities of continuing operations	575	3,464	42,015	36,256
Cash flows from financing activities of continuing operations:				
Payments on capital lease obligations	(2,428)	(5,247)	(9,363)	(5,776)
Drawdown on line of credit	30,728	1,169	42,596	57,122
Payments on line of credit	(10,728)	(1,169)	(22,596)	(77,122)
Payments to retire convertible senior notes			(35,670)	
Proceeds from the issuance of common stock, net of issuance costs				64,406
Purchase of treasury stock			(24,133)	
Settlement of call options for cash			7,937	
Exercise of stock options and warrants	1,027	1,153	7,436	2,660
Net cash provided by (used in) financing activities of continuing operations	18,599	(4,094)	(33,793)	41,290
Effect of exchange rate changes on cash	15	(15)	119	4
Cash (used in) provided by operating activities of discontinued operations				
Cash used in investing activities of discontinued operations	(176)	410	(221)	2,167
Cash used in financing activities of discontinued operations	(41)	(53)	(139)	(578)
Net (decrease) increase in cash and cash equivalents	(53,606)	(58,528)	(35,485)	67,184
Change in cash and cash equivalents from discontinued operations	217	(357)	360	(1,590)

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Cash and cash equivalents, beginning of period	55,875	126,965	37,611	2,486
Cash and cash equivalents, end of period	\$ 2,486	\$ 68,080	\$ 2,486	\$ 68,080
Supplemental disclosures of cash flow information:				
Interest paid	\$ 278	\$ 651	\$ 4,800	\$ 4,050
Deemed dividend on redeemable common stock	\$ 33	\$	\$ 172	\$ 66
Lapse of rescission rights on redeemable common stock	\$ 554	\$	\$ 700	\$ 2,750
Equipment and software acquired under capital leases	\$ 2,273	\$	\$ 2,822	\$
Settlement of purchased call options for treasury stock	\$	\$	\$ 41,121	\$
Fair value of assets acquired	\$	\$	\$ 26,447	\$
Fair value of liabilities assumed			(1,336)
Cash paid to purchase business	\$	\$	\$ 25,111	\$

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

Overstock.com, Inc.

Notes to Unaudited Consolidated Financial Statements

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by Overstock.com, Inc. (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the audited annual consolidated financial statements and related notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2006. The accompanying unaudited consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of results for the interim periods presented. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

2. ACCOUNTING POLICIES

Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The consolidated financial statements also include the accounts of a variable interest entity for which the Company was the primary beneficiary through November 30, 2006. All significant intercompany account balances and transactions have been eliminated in consolidation.

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.

Internal-Use Software and Website Development

Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance websites and processes supporting the business of the Company. As required by Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Company capitalizes costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During the first quarters of 2006 and 2007, the Company capitalized \$8.1 million and \$1.3 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$559,000 and \$776,000 for those respective periods.

Advertising expense

The Company recognizes advertising expenses in accordance with SOP 93-7 *Reporting on Advertising Costs*. As such, the Company expenses the costs of producing advertisements at the time production occurs or the first time the advertising takes place, and expenses the cost of communicating advertising in the period during which the advertising space or airtime is used. Internet advertising expenses are recognized as incurred based on the terms of the individual agreements, which are generally: 1) during the period customers are acquired; or 2) based on the number of clicks generated during a given period over the term of the contract. Advertising expense included in sales and marketing expenses totaled \$12.5 million and \$10.6 million during the three months ended March 31, 2006 and 2007, respectively.

Stock-based Compensation

As of January 1, 2006, the Company adopted SFAS 123(R) *Share-based Payment - an Amendment of FASB Statements No 123 and 95*, which requires the Company to measure compensation expense for all outstanding unvested share-based awards at fair value and recognize compensation expense over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires

judgment, and to the extent actual results differ from estimates,

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such amounts will be recorded as an adjustment in the period estimates are revised. Management considers many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates.

Recent accounting pronouncements

In March 2006, the Emerging Issue Task Force reached a consensus on Issue No. 06-03 *How Taxes Collected from Customers and Remitted to Government Authorities Should be Presented in the Income Statement (That Is, Gross versus Net Presentation)* (EITF No. 06-03). The Company adopted the provisions of EITF No. 06-03 beginning January 1, 2007. The adoption of EITF No. 06-03 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return.

The Company adopted the provisions of FIN 48, on January 1, 2007. As a result of a full valuation allowance, the Company does not have any unrecognized tax benefits and there is no effect on its financial condition or results of operations as a result of implementing FIN 48. The Company is subject to audit by the IRS and various states for the prior 3 years. The Company does not believe there will be any material changes in its unrecognized tax positions over the next 12 months. The Company's policy is that it recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the quarter ended March 31, 2007.

The Company recognized no income tax benefit from the net loss generated in the three months ended March 31, 2006 and 2007. Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, requires that a valuation allowance be provided if it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company's ability to realize the benefit of its deferred tax asset will depend on the generation of future taxable income through profitable operations. As of March 31, 2007, the Company has established a full valuation allowance against its deferred tax assets.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of this standard apply to other accounting pronouncements that require or permit fair value measurements. The Company will adopt SFAS 157 on January 1, 2008. The Company anticipates that the adoption of SFAS 157 will not have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, or SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for the Company's fiscal year beginning January 1, 2008. The Company anticipates that the adoption of SFAS No. 159 will not have a material impact on the Company's consolidated financial statements.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. In addition, the Company has revised its consolidated statements of cash flows for the year ended December 31, 2006 to present the operating and investing portion of the cash flows attributable to discontinued operations on a separately identifiable basis. The effect of these reclassifications had no impact on net income, total assets, total liabilities, or stockholders' equity.

3. RESTRUCTURING EXPENSE

During the fourth quarter of 2006, the Company commenced implementation of a facilities consolidation and restructuring program designed to reduce the overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program should be substantially completed during calendar year 2007.

During the fiscal year 2006, the Company recorded \$5.7 million of restructuring charges, of which \$5.5 million, less the elimination of straight-line rent liability of \$913,000, related to costs to terminate a co-location data-center lease. Other costs included in the restructuring

charge related to \$638,000 of accelerated amortization of leasehold improvements in the

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Company's current office facilities that it is attempting to sublease and \$450,000 of costs incurred to return these office facilities to their original condition as required by the Company's lease agreement.

In the first quarter of 2007, the Company accrued \$4.6 million of restructuring charges related to the termination of a logistics services agreement and its vacated warehouse facilities in Indiana. The Company also recorded an additional \$954,000 of restructuring charges related to accelerated amortization of leasehold improvements in the Company's current corporate office facilities that it is attempting to sublease, and \$487,000 of other miscellaneous restructuring charges.

Restructuring liabilities along with charges to expense, cash payments or accelerated amortization of leasehold improvements associated with the facilities consolidation and restructuring program were as follows (in thousands):

	Balance 12/31/2006	Charges to expense	Cash payment or accelerated amortization	Balance 3/31/2007
Lease and contract termination costs	\$ 5,499	\$ 4,648	\$ (5,499)	\$ 4,648
Asset retirement obligation	450		(48)	402
Accelerated amortization of leasehold improvements		954	(954)	
Other restructuring expenses		487	(487)	
Total	\$ 5,949	\$ 6,089	\$ (6,988)	\$ 5,050

Lease and contract termination costs relate primarily to the termination of leases in conjunction with the consolidation of the IT data center and co-location facilities and Indiana logistics services and warehouses agreements. The accelerated amortization of leasehold improvements relates to our current office facilities that we are attempting to sublease within the year. Other restructuring expenses are costs related to the reduction of data center space and corporate headcount.

4. DISCONTINUED OPERATIONS

On July 1, 2005, the Company acquired all the outstanding capital stock of Ski West, Inc. (Ski West) for an aggregate of \$25.1 million (including \$111,000 of capitalized acquisition related expenses).

Ski West is an on-line travel company whose proprietary technology provides easy consumer access to a large, fragmented, hard-to-find inventory of lodging, vacation, cruise and transportation bargains. The travel offerings are primarily in popular ski areas in the U.S. and Canada, with more recent expansion into the Caribbean and Mexico, as well as cruises. Effective upon the closing, Ski West became a wholly-owned subsidiary of the Company, integrated the Ski West travel offerings with the Company's existing travel offerings and changed its name to OTravel.com, Inc.

During the fourth quarter of 2006, in conjunction with the facilities consolidation and restructuring program described in Note 3, management decided to sell OTravel. The Company evaluated its plan to sell OTravel in accordance with SFAS 144, which requires that long-lived assets be classified as held for sale only when certain criteria are met. The Company has classified the OTravel assets and liabilities as held for sale as it has met these criteria as of December 31, 2006 and March 31, 2007, which include: management's commitment to a plan to sell the assets; the availability of the assets for immediate sale in their present condition; an active program to locate buyers and other actions to sell the assets has been initiated; the sale of the assets is probable and their transfer is expected to qualify for recognition as a completed sale within one year; the assets are being marketed at reasonable prices in relation to their fair value; and the unlikelihood that significant changes will be made to the plan to sell the assets. The travel business is not part of the Company's core business operations or its strategic focus. The results of operations for the subsidiary were included in the fulfillment partner segment prior to being classified as discontinued operations.

The Company also determined that the OTravel subsidiary meets the definition of a component of an entity and has been accounted for as a discontinued operation under SFAS 144. The results of operations for this subsidiary have been classified as discontinued operations in all periods presented. In conjunction with the discontinuance of OTravel, the Company performed an evaluation of the goodwill associated with the reporting unit pursuant to SFAS 142, and SFAS 144, *Accounting for the Impairment of Long-Lived Assets* and determined that goodwill of approximately \$4.5 million was impaired as of December 31, 2006 based on a non-binding letter of intent from a third party to purchase this business. During the quarter ended March 31, 2007, the Company received a revised offer from this third party to purchase its OTravel business, and in April 2007, the Company completed the sale of OTravel under these revised terms. Accordingly, the Company evaluated its goodwill as of March 31, 2007 and based on the estimated fair value of the discounted cash flows of the net proceeds from the sale, determined that an additional \$3.8 million of goodwill was impaired.

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The following table is a summary of the Company's discontinued operations for the three months ended March 31, 2006 and 2007 (in thousands):

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	Three months ended March 31,	
	2006	2007
Sales	\$ 2,162	\$ 2,081
Cost of sales	(754)	(572)
Gross profit	1,408	1,509
Sales and marketing	(518)	(342)
Technology	(165)	(44)
General and administrative	(1,504)	(905)
Goodwill impairment		(3,842)
Loss from discontinued operations	\$ (779)	\$ (3,624)

The held for sale assets and liabilities consisted of the following (in thousands):

	December 31, 2006	March 31, 2007
Assets of held for sale subsidiary:		
Cash	\$ 1,365	\$ 1,722
Accounts receivable	3,267	295
Property and equipment, net	1,215	1,268
Goodwill and intangible assets, net	15,379	11,537
Other	86	131
Total assets of discontinued operations	\$ 21,312	\$ 14,953
Liabilities of held for sale subsidiary:		
Current liabilities:		
Accounts payable	\$ 1,249	\$ 434
Accrued liabilities	912	559
Total liabilities of discontinued operations	\$ 2,161	\$ 993

On April 25, 2007, the Company completed the sale of its wholly owned subsidiary OTravel.com, Inc. to Castles Travel, Inc., an affiliate of Kinderhook Industries, LLC, and Castles Media Company LLC, for \$17.0 million. The proceeds include \$11.0 million in cash and two \$3.0 million promissory notes. The \$3.0 million senior note matures three years from the close date and bears interest, payable quarterly, of 4.0%, 10.0% and 14.0% per year in the first, second and third year, respectively. The \$3.0 million junior note matures five years from the close date and bears interest of 8.0% per year, compounding, and is payable at the termination of the note.

5. DERIVATIVE INSTRUMENTS

During the first quarter of 2005, the Company purchased \$49.9 million of Foreign Corporate Securities (Foreign Notes) which were scheduled to mature in November 2006. The Foreign Notes did not have a stated interest rate, but were structured to return the entire principal amount and a conditional coupon if held to maturity. The conditional coupon would provide a rate of return dependent on the performance of a basket of eight Asian currencies against the U.S. dollar. If the Company redeemed the Foreign Notes prior to maturity, the Company would not realize the full amount of its initial investment.

Under SFAS No. 133, the Foreign Notes are considered to be derivative financial instruments and were marked to market quarterly. Any unrealized gain or loss related to the changes in value of the conditional coupon was recorded in the income statement as a component of interest income or expense. Any unrealized gain or loss related to the changes in the value of the Foreign Notes was recorded as a component of accumulated other comprehensive income (loss).

The Company purchased the Foreign Notes to manage its foreign currency risks related to the strengthening of Asian currencies compared to the U.S. dollar, which would reduce the inventory purchasing power of the Company in Asia. However, the Company determined that the Foreign Notes did not qualify as hedging derivative instruments. Nevertheless, management believes that such instruments are useful in managing the Company's associated risk.

On April 26, 2006, the Company sold the Foreign Notes for \$49.5 million resulting in a gain on the bond instrument of \$1.9 million, which the Company recognized in the second quarter of 2006 as a component of interest income. The Company had previously recorded \$2.4 million of

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accumulated unrealized losses as a component of interest income over the period the bonds had been held.

The Company had pledged its Foreign Notes as collateral for a \$30.0 million revolving line of credit. Subsequent to the sale of the Foreign Notes, the borrowings under the Amended Credit Agreement (see Note 11) are now collateralized by cash balances held at Wells Fargo Bank, N.A.

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6. OTHER COMPREHENSIVE LOSS

The Company follows SFAS No. 130, *Reporting Comprehensive Income*. This Statement establishes requirements for reporting comprehensive income (loss) and its components. The Company's comprehensive loss is as follows (in thousands):

	Three months ended March 31,	
	2006	2007
Net loss	\$ (15,910)	\$ (21,383)
Unrealized gain on Foreign Notes	485	
Foreign currency translation adjustment	15	(15)
Comprehensive loss	\$ (15,410)	\$ (21,398)

7. EARNINGS (LOSS) PER SHARE

In accordance with SFAS 128 *Earnings per share*, basic earnings (loss) per share is computed by dividing net income (loss) attributable to common shares by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) attributable to common shares for the period by the weighted average number of common and potential common shares outstanding during the period. Potential common shares, composed of incremental common shares issuable upon the exercise of stock options, warrants and convertible senior notes, are included in the calculation of diluted net loss per share to the extent such shares are dilutive.

The following table sets forth the computation of basic and diluted earnings (loss) per share for the periods indicated (in thousands, except per share amounts):

	Three months ended March 31,	
	2006	2007
Loss from continuing operations	\$ (15,131)	\$ (17,759)
Deemed dividend related to redeemable common stock	(33)	
Loss from continuing operations attributable to common shares	(15,164)	(17,759)
Loss from discontinued operations	(779)	(3,624)
Net loss attributable to common shares	\$ (15,943)	\$ (21,383)
Weighted average common shares outstanding basic	19,385	23,594
Effective of dilutive securities:		
Stock options		
Convertible senior notes		
Weighted average common shares outstanding diluted	19,385	23,594
Net loss per common share basic and diluted:		
Loss from continuing operations	\$ (0.78)	\$ (0.75)
Loss from discontinued operations	\$ (0.04)	\$ (0.16)
Net loss per common share basic and diluted	\$ (0.82)	\$ (0.91)

The stock options, warrants and convertible senior notes outstanding were not included in the computation of diluted earnings per share because to do so would have been antidilutive. The number of shares of stock options outstanding at March 31, 2006 and 2007 was 1,181,000 shares and 1,376,000 shares, respectively. As of March 31, 2007, the Company had \$77.0 million of convertible senior notes outstanding, which could potentially convert into 1,010,000 shares of common stock in the aggregate.

8. BUSINESS SEGMENTS

Segment information has been prepared in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Segments were determined based on products and services provided by each segment. There were no inter-segment sales or transfers during the three months ended March 31, 2006 or 2007. The Company evaluates the performance of its segments and allocates resources to them based primarily on gross profit. The table below summarizes information about reportable segments for the three months ended March 31, 2006 and 2007 (in thousands):

	Three months ended March 31,		Consolidated
	Direct	Fulfillment partner	
2006			
Revenue	\$ 79,710	\$ 98,334	\$ 178,044
Cost of goods sold	70,703	83,587	154,290
Gross profit	\$ 9,007	\$ 14,747	23,754
Operating expenses			(37,933)
Other income (expense), net			(952)
Loss from continuing operations			\$ (15,131)
2007			
Revenue	\$ 45,701	\$ 112,229	\$ 157,930
Cost of goods sold	39,320	93,295	132,615
Gross profit	\$ 6,381	\$ 18,934	25,315
Operating expenses			(43,035)
Other income (expense), net			(39)
Loss from continuing operations			\$ (17,759)

The direct segment includes revenues, direct costs, and allocations associated with sales fulfilled from our warehouses. Costs for this segment include product costs, inbound and outbound freight, warehousing and fulfillment costs, credit card fees and customer service costs.

The fulfillment partner segment includes revenues, direct costs and cost allocations associated with the Company's third party fulfillment partner sales and are earned from selling the merchandise of third parties over the Company's Websites. The costs for this segment include product costs, warehousing and fulfillment costs, credit card fees and customer service costs.

Assets have not been allocated between the segments for management purposes, and as such, they are not presented here.

For the three months ended March 31, 2006 and 2007, over 99% of sales were made to customers in the United States of America. No individual geographical area within the U.S accounted for more than 10% of net sales in any of the periods presented. At December 31, 2006 and March 31, 2007, all of the Company's fixed assets were located in the United States of America.

9. PERFORMANCE SHARE PLAN

In January 2006, the Board and Compensation Committee adopted the Overstock.com Performance Share Plan, and approved grants to executive officers and certain employees of the Company. The Performance Share Plan provides for a three-year period for the measurement of the Company's attainment of the performance goal described in the form of grant, but at the Company's sole option the Company may make a payment of estimated amounts payable to a plan participant after two years.

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of the Company's common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan will be payable in cash. During interim and annual periods prior to the completion of the three-year measurement period, the Company records compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates include assumed future growth rates in revenues, gross margins and other factors. If the Company were to use different assumptions, the estimated compensation charges could be significantly different.

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Approximately \$400,000 and \$250,000 of compensation expense under the plan has been included in general and administrative expenses for the quarters ended March 31, 2006 and 2007, respectively. As of March 31, 2007, the Company has accrued \$1.2 million in total compensation expense under the plan.

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10. BORROWINGS

\$30.0 million Amended Credit Agreement

On October 18, 2005, the Company entered into a sixth amendment to a credit agreement (Amended Credit Agreement) with Wells Fargo Bank, N.A. The Amended Credit Agreement provides a revolving line of credit to the Company of up to \$30.0 million which the Company uses primarily to obtain letters of credit to support inventory purchases. The Amended Credit Agreement expires on December 31, 2007; however, the Company has an option to renew the Amended Credit Agreement annually. Interest on borrowings is payable monthly and accrued at either (i) 1.35% above LIBOR in effect on the first day of an applicable fixed rate term, or (ii) at a fluctuating rate per annum determined by the bank to be one half a percent (0.50%) above daily LIBOR in effect on each business day a change in daily LIBOR is announced by the bank. Unpaid principal, together with accrued and unpaid interest is due on the maturity date. The Amended Credit Agreement requires the Company to comply with certain covenants, including restrictions on mergers, business combinations or transfer of assets. The Company was in compliance with these covenants at March 31, 2007.

Borrowings and outstanding letters of credit under the Amended Credit Agreement are collateralized by cash balances held at Wells Fargo Bank, N.A.

At March 31, 2007, no amounts were outstanding under the Amended Credit Agreement, and Letters of Credit totaling \$8.3 million were issued on behalf of the Company.

\$40.0 million WFRF Agreement

On December 12, 2005, the Company entered into a Loan and Security Agreement (the WFRF Agreement) with Wells Fargo Retail Finance, LLC and related security agreements and other agreements described in the WFRF Agreement.

The WFRF Agreement provides for advances to the Company and for the issuance of letters of credit for its account of up to an aggregate maximum of \$40.0 million. The Company has the right to increase the aggregate maximum amount available under the facility to up to \$50.0 million during the first two years of the facility. The amount actually available to the Company may be less and may vary from time to time, depending on, among other factors, the amount of its eligible inventory and receivables. The Company's obligations under the WFRF Agreement and all related agreements are collateralized by all or substantially all of the Company's and its subsidiaries' assets. The Company's obligations under the WFRF Agreement are cross-collateralized with its assets pledged under its \$30.0 million credit facility with Wells Fargo Bank, N.A. The term of the WFRF Agreement is three years, expiring on December 12, 2008. The WFRF Agreement contains standard default provisions.

Advances under the WFRF Agreement bear interest at either (a) the rate announced, from time to time, within Wells Fargo Bank, N.A. at its principal office in San Francisco as its prime rate or (b) a rate based on LIBOR plus a varying percentage between 1.25% and 1.75%; however, the annual interest rate on advances under the WFRF Agreement will be at least 3.50%. The WFRF Agreement includes affirmative covenants as well as negative covenants that prohibit a variety of actions without the lender's approval, including covenants that limit the Company's ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another person, (d) sell assets, (e) change its name or the name of any of its subsidiaries, (f) make certain changes to its business, (g) optionally prepay, acquire or refinance indebtedness, (h) consign inventory, (i) pay dividends on, or purchase, acquire or redeem shares of, its capital stock, (j) change its method of accounting, (k) make investments, (l) enter into transactions with affiliates, or (m) store any of its inventory or equipment with third parties. The Company was in compliance with these covenants as of March 31, 2007. At March 31, 2007, no amounts were outstanding under the WFRF Agreement. As of March 31, 2007, availability under the WFRF Agreement was \$6.2 million.

Capital leases

The Company leases certain software and computer equipment under three non-cancelable capital leases that expire at various dates through 2008.

Software and equipment relating to the capital leases totaled \$17.7 million and \$19.8 million at December 31, 2006 and March 31, 2007, respectively, with accumulated amortization of \$12.4 million and \$14.1 million at those respective dates.

Depreciation of assets recorded under capital leases was \$1.5 million and \$1.8 million for the three months ended March 31, 2006 and 2007, respectively. The Company expects that in the normal course of business, the leases will expire.

Future minimum lease payments under capital leases are as follows (in thousands):

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Twelve months ending March 31, 2008	\$ 4,101
Less: amount representing interest	(291)
Present value of capital lease obligations	3,810
Less: current portion	(3,810)
Capital lease obligations, non-current	\$

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11. 3.75% CONVERTIBLE SENIOR NOTES

In November 2004, the Company completed an offering of \$120.0 million of 3.75% Convertible Senior Notes (the *Senior Notes*). Proceeds to the Company were \$116.2 million, net of \$3.8 million of initial purchaser's discount and debt issuance costs. The discount and debt issuance costs are being amortized using the straight-line method which approximates the interest method. During the three months ended March 31, 2006 and 2007, the Company recorded amortization of discount and debt issuance costs related to this offering totaling \$86,000 for both periods. Interest on the Senior Notes is payable semi-annually on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2011 and are unsecured and rank equally in right of payment with all existing and future unsecured, unsubordinated debt and senior in right of payment to any existing and future subordinated indebtedness.

The Senior Notes are convertible at any time prior to maturity into the Company's common stock at the option of the note holders at a conversion price of \$76.23 per share or, approximately 1,010,000 shares in aggregate (subject to adjustment in certain events, including stock splits, dividends and other distributions and certain repurchases of the Company's stock, as well as certain fundamental changes in the ownership of the Company). Beginning December 1, 2009, the Company has the right to redeem the Senior Notes, in whole or in part, for cash at 100% of the principal amount plus accrued and unpaid interest. Upon the occurrence of a fundamental change (including the acquisition of a majority interest in the Company, certain changes in the Company's board of directors or the termination of trading of the Company's stock) meeting certain conditions, holders of the Senior Notes may require the Company to repurchase for cash all or part of their notes at 100% of the principal amount plus accrued and unpaid interest.

The indenture governing the Senior Notes requires the Company to comply with certain affirmative covenants, including making principal and interest payments when due, maintaining our corporate existence and properties, and paying taxes and other claims in a timely manner. The Company was in compliance with these covenants at March 31, 2007.

In June and November 2005, the Company retired \$33.0 million and \$10.0 million of the Senior Notes for \$27.9 million and \$7.8 million in cash for each respective retirement. As a result of the note retirements in June and November, the Company recognized gains of \$4.2 million and \$2.0 million, net of the associated unamortized discount of \$1.2 million during the quarters ended June 30, 2005 and December 31, 2005, respectively. As of March 31, 2007, \$77.0 million of the Senior Notes remained outstanding.

12. COMMITMENTS AND CONTINGENCIES

Commitments

Through July 2005, the Company leased 43,000 square feet of office space at Old Mill Corporate Center I for its principal executive offices under an operating lease which was originally scheduled to expire in January 2007. Beginning July 2005, this lease was terminated and replaced with a lease for approximately 154,000 rentable square feet in the Old Mill Corporate Center III in Salt Lake City, Utah for a term of ten years.

In February 2005, the Company and Old Mill Corporate Center III, LLC (the *Lessor*) entered into a Tenant Improvement Agreement (the *OMIII Agreement*) relating to the office building. The OMIII Agreement sets forth the terms on which the Company paid the costs of certain improvements to the leased office space. The amount of the costs was approximately \$2.0 million. The OMIII Agreement also required the Company to provide a letter of credit in the amount of \$500,000 to the Lessor to provide funds for the removal of certain improvements upon the termination of the lease.

During the fourth quarter 2006, the Company commenced implementation of a facilities consolidation and restructuring program (Note 3). The Company recorded a liability of \$450,000 for the costs to dismantle and dispose of an escalator system and to return the leased facilities to their original condition under the Tenant Improvement Agreement and incurred additional amortization expense in connection with the revised useful life of certain leasehold improvements. In January 2007, the Company began marketing its leased office facilities for sub-lease.

In July 2005, the Company entered into a Co-location Center Agreement (the *Co-location Agreement*) to build out and lease 11,289 square feet of space at Old Mill Corporate Center II for an IT data center and co-location facility. The Co-location Agreement set forth the terms on which the Lessor would incur the costs to build out the IT data center and co-location facility and the Company would commence to lease the space upon its completion for a term of ten years. In November 2006, the Company made the determination to consolidate its facilities and to not occupy the IT data center and co-location facility, and the lease agreement was terminated effective December 28, 2006 (see Note 3).

In July 2004, the Company entered into a logistics service agreement (the *Logistics Agreement*) wherein the handling,

storage and distribution of the Company's prepackaged products is performed by a third party. The Logistics Agreement and subsequent amendment set forth terms on which the Company paid various fixed fees based on square feet of storage and various variable costs based on product handling costs for a term of five years.

In December 2005, the Company entered into a warehouse facilities lease agreement (the License Agreement) to license approximately 400,000 square feet of warehouse space in Indiana. The License Agreement was subsequently amended, reducing the amount of lease space to approximately 300,000 and extending the term to 2011.

In the first quarter of 2007, the Company terminated the Logistics Agreement and gave notice of intent to sublease the Indiana warehouse facilities under the License Agreement (see Note 3).

The Company leases 610,000 square feet for its warehouse facilities in Utah under operating leases which expire in August 2012.

In June 2005 and 2006, the Company entered into non-cancelable operating leases for certain computer equipment expiring in April 2008 and June 2008. It is expected that such leases will be renewed by exercising purchase options or replaced by leases of other computer equipment.

Minimum future payments under these leases are as follows (in thousands):

Twelve months Ending March 31,

2008	\$ 11,901
2009	6,433
2010	5,812
2011	5,398
2012	5,371
Thereafter	14,885
	\$ 49,800

Rental expense for operating leases totaled \$1.3 million and \$1.6 million for the three months ended March 31, 2006 and 2007, respectively.

Redeemable Common Stock

The estimated amount of redeemable common stock is based solely on the statutes of limitations of the various states in which stockholders may have rescission rights and may not reflect the actual results. The stock is not redeemable by its terms. The Company does not have any unconditional purchase obligations, other long-term obligations, guarantees, standby repurchase obligations or other commercial commitments. These rescission rights fully expired prior to the end of the third quarter of 2006, leaving no outstanding redeemable common stock as of September 30, 2006 forward.

Legal Proceedings

From time to time, the Company receives claims of and become subject to consumer protection, employment, intellectual property and other commercial litigation related to the conduct of our business. Such litigation could be costly and time consuming and could divert our management and key personnel from its business operations. The uncertainty of litigation increases these risks. In connection with such litigation, the Company may be subject to significant damages or equitable remedies relating to the operation of its business and the sale of products on our websites. Any such litigation may materially harm its business, prospects, results of operations, financial condition or cash flows. However, the Company does not currently believe that any of its outstanding litigation will have a material adverse effect on its financial statements.

In December 2003, the Company received a letter from Furnace Brook claiming that certain of the Company's business practices and its website infringe a single patent owned by Furnace Brook. After diligent efforts to show that the Company does not infringe the patent and Furnace Brook's continual demands that the Company enter into licensing arrangements with respect to the asserted patent, on August 12, 2005, the Company filed a complaint in the United States District Court of Utah, Central Division, seeking declaratory judgment that it does not infringe any valid claim of the Furnace Brook patent. Furnace Brook filed a motion to dismiss that complaint for lack of personal jurisdiction over Furnace Brook in Utah. On October 31, 2005, the United States District Court of Utah, Central Division, issued a decision to dismiss the Company's complaint for lack of personal jurisdiction over patent troll Furnace Brook. On December 14, 2005, the Company filed an appeal of the Utah decision with the United States Court of Appeals for the Federal Circuit. On August 18, 2006, the United States Court of Appeals for the Federal Circuit denied the Company's appeal. On August 18, 2005, shortly after the Company filed the complaint in Utah, Furnace Brook

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filed a complaint in the United States District Court for the Southern District of New York, alleging that certain of the Company's business practices and its website infringe a single patent owned by Furnace Brook. On September 9, 2005, the Company filed an answer denying the material allegations in Furnace Brook's claims. On

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September 27, 2006, the United States District Court for the Southern District of New York issued a memorandum and order in a Markman Hearing which substantially adopted the Company's interpretation of the Furnace Brook patent. The Company filed motions for summary judgment relating to the litigation and on October 6, 2006, the United States District Court for the Southern District of New York heard oral argument on those motions and on October 30, 2006, the United States District Court for the Southern District of New York granted summary judgment in favor of the Company, ruling that the Company does not infringe the Furnace Brook patent as a matter of law. On November 9, 2006, Furnace Brook filed a notice of appeal to the United States Court of Appeals for the Federal Circuit. On January 16, 2007, the Company filed a brief with the Federal Circuit Court and the appeal is now pending. Oral argument on the appeal scheduled for May 10, 2007.

On August 11, 2005, along with a shareholder plaintiff, the Company filed a complaint against Gradient Analytics, Inc.; Rocker Partners, LP; Rocker Management, LLC; Rocker Offshore Management Company, Inc. and their respective principals in the Superior Court of California, County of Marin. On October 12, 2005, the Company filed an amended complaint against the same entities alleging libel, intentional interference with prospective economic advantage and violations of California's unfair business practices act. On March 7, 2006, the court denied the defendants demurrers to and motions to strike the amended complaint. The defendants each filed a motion to appeal the court's decision, the Company responded and the California Attorney General submitted an amicus brief supporting the Company's view; the court has ruled that this appeal stays discovery in the case. On April 10, 2007, the California Court of Appeals heard oral argument on the appeal; the California Court of Appeals has not yet issued its decision. The Company intends to pursue this action vigorously.

On May 9, 2006 the Company received a notice of an investigation and subpoena from the Securities and Exchange Commission, Salt Lake City District Office. On May 17, 2006, Patrick Byrne also received a subpoena from the Securities and Exchange Commission, Salt Lake City District Office. These subpoenas requested a broad range of documents, including, among other documents, all documents relating to the Company's accounting policies, the Company's targets, projections or estimates related to financial performance, the Company's recent restatement of its financial statements, the filing of its complaint against Gradient Analytics, Inc., the development and implementation of certain new technology systems and disclosures of progress and problems with those systems, communications with and regarding investment analysts, communications regarding shareholders who did not receive the Company's proxy statement in April 2006, communications with certain shareholders, and communications regarding short selling, naked short selling, purchases and sales of Company stock, obtaining paper certificates, and stock loan or borrow of Company shares. The Company and Mr. Byrne have responded to these subpoenas and each continues to cooperate with the Securities and Exchange Commission on this matter.

In November 2006, the Company received a letter from Applied Interactive, claiming that certain of the Company's business practices and its website infringe two patents owned by Applied Interactive and offering to enter into a licensing agreement. After determining that it does not infringe the patents and rejecting the offered licensing agreement, on February 2, 2007, the Company filed a complaint in the United States District Court, Southern District of New York, seeking declaratory judgment that it did not infringe any valid claim of the Applied Interactive patents. The Company and Applied Interactive have reached a confidential agreement in principal to settle this matter for an immaterial amount. The parties will dismiss the suit with prejudice once this agreement has been memorialized.

On February 2, 2007, along with five shareholder plaintiffs, the Company filed a lawsuit in the Superior Court of California, County of San Francisco against Morgan Stanley & Co. Incorporated, Goldman Sachs & Co., Bear Stearns Companies, Inc., Bank of America Securities LLC, Bank of New York, Citigroup Inc., Credit Suisse (USA) Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., and UBS Financial Services, Inc. The suit alleges that the defendants, who control over 80% of the prime brokerage market, participated in an illegal stock market manipulation scheme and that the defendants had no intention of covering short sell orders with borrowed stock, as they are required to do, causing what are referred to as "fails to deliver" and that the defendants' actions caused and continue to cause dramatic distortions with in the nature and amount of trading in the Company's stock as well as dramatic declines in the share price of the Company's stock. The suit asserts that a persistent large number of "fails to deliver" creates significant downward pressure on the price of a company's stock and that the amount of "fails to deliver" has exceeded the company's entire supply of outstanding shares. The suit accuses the defendants of violations of California securities laws and common law, specifically, conversion, trespass to chattels, intentional interference with prospective economic advantage, and violations of California's Unfair Business Practices Act. The Company is seeking damages of \$3.48 billion. The case is in its initial stages. The Company intends to vigorously prosecute this action.

On March 29, 2007, the Company, along with 63 other defendants, was sued in United States District Court for the Eastern District of Texas, Tyler Division, by Orion IP, LLC. The suit alleges that the Company and the other 63 defendants infringe two patents owned by Orion that relate to the making and using supply chain methods, sales methods, sales systems, marketing methods, marketing systems, and inventory systems. On April 30, 2007, the Company filed an answer denying Orion's allegations and a counterclaim asserting that Orion's patent is invalid. The case is in its initial stages. As it has consistently done with similar suits filed by patent trolls, the Company intends to vigorously defend this action.

13. INDEMNIFICATIONS AND GUARANTEES

During its normal course of business, the Company has made certain indemnities, commitments, and guarantees

under which it may be required to make payments in relation to certain transactions. These indemnities include, but are not limited to, indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. The duration of these indemnities, commitments, and guarantees varies, and in certain cases, is indefinite. In addition, the majority of these indemnities, commitments, and guarantees do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. As such, the Company is unable to estimate with any reasonableness its potential exposure under these items. The Company has not recorded any liability for these indemnities, commitments, and guarantees in the accompanying consolidated balance sheets. The Company does, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is both probable and reasonably estimable. The Company carries specific and general liability insurance policies that the Company believes would, in most circumstances, provide some, if not total coverage for any claims arising from these indemnifications.

14. STOCK OFFERINGS

During 2006, the Company closed two offerings under an existing shelf registration statement, pursuant to which it sold 1.0 million shares of common stock in May and 2.7 million shares of common stock in December, with proceeds to the Company of approximately \$25.0 million and \$39.4 million, respectively, net of \$594,000 of issuance costs. The Company has made no offerings in 2007.

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

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements. These statements relate to our, and in some cases our customers' or other third parties', future plans, objectives, expectations, intentions and financial performance and the assumptions that underlie these statements. These forward-looking statements include, but are not limited to, statements regarding the following: our beliefs and expectations regarding the seasonality of our direct and fulfillment partner revenue; our beliefs regarding the sufficiency of our capital resources; planned distribution and order fulfillment capabilities; our beliefs, intentions and expectations regarding improvements of our order processing systems and capabilities; our intentions regarding the development of enhanced technologies and features; our intentions regarding the expansion of our customer service capabilities; our belief and intentions regarding improvements to our general and administrative functions; our beliefs and intentions regarding enhancements to our sales and marketing activities; our beliefs regarding the potential for growth in our customer base; our beliefs and intentions regarding our expansion into new markets, including international markets; our beliefs and intentions about entering into agreements to provide products and services to retail chains and other businesses; our belief regarding potential development of new Websites; our beliefs, intentions and expectations regarding promotion of new or complimentary product and sales formats; our belief, intentions and expectations regarding the expansion of our product and service offerings; our beliefs and intentions regarding expanding our market presence through relationships with third parties; our beliefs regarding the pursuit of complimentary businesses and technologies; our beliefs regarding the adequacy of our insurance coverage; our beliefs, intentions and expectations regarding litigation matters and legal proceedings, our defenses to such matters and our contesting of such matters; our beliefs and expectations regarding our existing cash and cash equivalents, cash requirements and sufficiency of capital; and our beliefs and expectations regarding interest rate risk, our investment activities and the effect of changes in interest rates.

These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties please see Item 1A Risk Factors and the description of risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2006. These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.

Recent Developments

During the fourth quarter of 2006, we commenced implementation of a facilities consolidation and restructuring program designed to reduce our overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program should be substantially completed during calendar year 2007.

As of December 31, 2006, we recorded \$5.7 million of restructuring charges, of which \$5.5 million, less the elimination of straight-line rent liability of \$913,000, related to costs to terminate a co-location data-center lease. Other costs included in the restructuring charge related to \$638,000 of accelerated amortization of leasehold improvements in our current office facilities that we are attempting to sublease and \$450,000 of costs incurred to return these office facilities to their original condition as required by the lease agreement.

In the first quarter of 2007, we accrued \$4.6 million of restructuring charges related to the termination of a logistics services agreement and our vacated warehouse facilities in Indiana. We also recorded an additional \$954,000 of restructuring charges related to accelerated amortization of leasehold improvements in our current corporate office facilities that we are attempting to sublease, and \$487,000 of other miscellaneous restructuring charges.

We have classified \$15.0 million of assets and \$993,000 of liabilities as held for sale related to our OTravel subsidiary. In conjunction with the discontinuance of OTravel, we performed an evaluation of the goodwill associated with the reporting unit pursuant to SFAS 142, and SFAS 144, *Accounting for the Impairment of Long-Lived Assets* and determined that goodwill of approximately \$4.5 million was impaired as of December 31, 2006 based on a non-binding letter of intent to purchase this business. On April 25, 2007, the Company completed the sale of OTravel for \$11.0 million of cash and \$6.0 million of notes. Based on the estimated fair value of the discounted cash flows of the net proceeds from the sale, the Company recorded an additional goodwill impairment of \$3.8 million as of March 31, 2007 (see Financial Statements Note 3 Discontinued Operations).

Please see the Executive Commentary below as well as the rest of Management's Discussion and Analysis for discussion of other recent developments.

Overview

We are an online closeout retailer offering discount brand name merchandise, including bed-and-bath goods, home décor, kitchenware, watches, jewelry, electronics and computers, sporting goods, apparel, and designer accessories, among other products. We also sell books, magazines, CDs, DVDs, videocassettes and video games (BMMG). We also operate as part of our Website an online auction site a marketplace for the buying and selling of goods and services as well as an online site for listing cars for sale.

Our company, based in Salt Lake City, Utah, was founded in 1997, and we launched our first Website through which customers could purchase products in March 1999. Our Websites offer our customers an opportunity to shop for bargains conveniently, while offering our suppliers an alternative inventory liquidation distribution channel. We continually add new, limited inventory products to our Websites in order to create an atmosphere that encourages customers to visit frequently and purchase products before our inventory sells out. We offer approximately 36,000 products under multiple shopping tabs on our main website, plus almost 500,000 media products on our BMMG tab.

Closeout merchandise is typically available in inconsistent quantities and prices and often is only available to consumers after it has been purchased and resold by disparate liquidation wholesalers. We believe that the traditional liquidation market is therefore characterized by fragmented supply and fragmented demand. We utilize the Internet to aggregate both supply and demand and create a more efficient market for liquidation merchandise. Our objective is to provide a one-stop destination for discount shopping for products and services proven to be successfully sold through the Internet.

Our Business

Overstock utilizes the Internet to create a more efficient market for liquidation merchandise. We provide consumers and businesses with quick and convenient access to high-quality, brand-name merchandise at discount prices. Our shopping business includes both a direct business and a fulfillment partner business. During the quarter ended March 31, 2007, no single customer accounted for more than 1% of our total revenue. Products from our direct segment and fulfillment partner segment are available to both consumers and businesses through our Wholesale bulk purchase program.

Direct business

Our direct business includes sales made to individual consumers and businesses, which are fulfilled from our warehouses in Salt Lake City, Utah or our outsourced warehouses located in Plainfield, Indiana. During the quarter ended March 31, 2007, we fulfilled approximately 25% of all orders through our warehouses. Our warehouses generally ship between 5,000 and 8,000 orders per day, and up to approximately 34,000 orders per day during peak periods, using overlapping daily shifts.

Fulfillment partner business

For our fulfillment partner business, we sell merchandise of other retailers, cataloguers or manufacturers (fulfillment partners) through our Website. We are considered to be the primary obligor for the majority of these sales transactions, and we assume the risk of loss on the returned items. As a consequence, we record revenue from the majority of these sales transactions involving our fulfillment partners on a gross basis. Our use of the term partner or fulfillment partner does not mean that we have formed any legal partnerships with any of our fulfillment partners. We currently have fulfillment partner relationships with approximately 485 third parties which post approximately 26,000 non-BMMG products, as well as most of the BMMG products on our Websites.

Our revenue from sales on our shopping site from both the direct and fulfillment partner businesses is recorded net of returns, coupons and other discounts. Our returns policy for products other than those sold in our Electronics and Computers department provides for a \$4.95 restocking fee and the provision that we will accept product returns initiated within thirty days after the shipment date. We charge a 15% restocking fee (instead of the \$4.95 restocking fee) on all items returned for non-defective reasons from the Electronics and Computers department.

Unless otherwise indicated or required by the context, the discussion herein of our financial statements, accounting policies and related matters, pertains to our shopping sites (Shopping and BMMG) and not necessarily to our wholesale, auction, or cars tabs on our Websites.

Wholesale business

In August 2004, we merged our B2B site (www.overstockb2b.com) into our B2C site, and during 2005, we integrated this into our Wholesale tab, which allows consumers and businesses to purchase selected products in bulk quantities. For this tab, we have added a number of suppliers specific to various industry verticals, such as florist supplies, restaurant supplies, and office supplies.

Auctions business

We operate an online auction service as part of our Website. Our auction tab allows sellers to list items for sale, buyers to bid on items of interest, and users to browse through listed items online. For these sales we record only our listing fees and commissions for items sold as revenue. From time to time, we also sell items returned from our shopping site on our auction site, and for these sales, we record the revenue on a gross basis. Revenue from our auction business is

included in the fulfillment partner segment, as it is not significant enough to segregate as its own segment.

Cars listing business

We operate an online site for listing cars for sale as a part of our Website. The cars listing service allows sellers to list vehicles for sale and allows buyers to review vehicle descriptions, post offers to purchase, and provides the means for purchasers to contact sellers for further information and negotiations on the purchase of an advertised vehicle. Revenue from our cars listing business is included in the fulfillment partner segment, as it is not significant enough to separate out as its own segment.

Cost of goods sold

Cost of goods sold consists of the cost of the product, as well as inbound and outbound freight, warehousing and fulfillment costs (including payroll and related expenses), credit card fees, customer service costs and stock-based compensation.

Operating expenses

Sales and marketing expenses consist primarily of advertising, public relations and promotional expenditures, as well as payroll and related expenses, including stock-based compensation, for personnel engaged in marketing and selling activities.

Advertising expense is the largest component of our sales and marketing expenses and is primarily attributable to expenditures related to online marketing activities and offline national radio and television advertising. For the three months ended March 31, 2006 and 2007, our advertising expenses totaled approximately \$12.5 million and \$10.6 million, respectively, representing 98% and 94%, respectively, of sales and marketing expenses.

Technology expenses consist of wages and benefits, including stock-based compensation, for technology personnel, rent, utilities, connectivity charges, as well as support and maintenance and depreciation and amortization related to software and computer equipment.

General and administrative expenses consist of wages and benefits, including stock-based compensation, for executive, legal, accounting, merchandising and administrative personnel, rent and utilities, travel and entertainment, depreciation and amortization of intangible assets and other general corporate expenses.

We have recorded no provision or benefit for federal and state income taxes as we have incurred net operating losses since inception. We have provided a full valuation allowance on the net deferred tax assets, consisting primarily of net operating loss carryforwards, because of uncertainty regarding their realizability.

Both direct and fulfillment partner revenues are seasonal, with revenues historically being the highest in the fourth quarter, reflecting higher consumer holiday spending. We anticipate this will continue in the foreseeable future.

Executive Commentary

This executive commentary is intended to provide investors with a view of our business through the eyes of our management. As an executive commentary, it necessarily focuses on selected aspects of our business. This executive commentary is intended as a supplement to, but not a substitute for, the more detailed discussion of our business included elsewhere herein. Investors are cautioned to read our entire Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as our interim and audited financial statements, and the discussion of our business and risk factors and other information included elsewhere in this report. This executive commentary includes forward-looking statements, and investors are cautioned to read the Special Note Regarding Forward-Looking Statements included elsewhere in this report.

Commentary Revenue and Marketing. Our first quarter revenue declined 11% from the first quarter of 2006. We believe that this decrease is primarily the result of a reduction in traffic to the Website due to a significant reduction in marketing expense as a percent of sales in the quarter (7.1%) compared to the previous two quarters (11.0% and 9.8%, respectively).

We believe that the keys to future revenue growth are to increase our Website conversion rate defined as the percentage of visitors to the website who make a purchase. The areas of our business that most directly affect conversion rate are personalization of the website, customer retention,

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e-mail marketing, site design and layout, and product selection. Within each of these areas, we have identified and made progress on initiatives that we believe can improve conversion, including an initiative to significantly increase the number of products within the existing stores on our Website by adding fulfillment partners that will enhance our current product offering.

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Commentary Gross Margins. Our gross margins reached an all-time high of 16.0% in the first quarter. We significantly cleaned and reduced our inventory over the course of 2006 in an effort to refine the selection of products that we purchase directly to categories that turn faster and have higher profitability. We believe that we can run our direct business with significantly less inventory than we have had in the past, while filling in product selection using fulfillment partners, rather than acquiring the inventory directly. As a result of these efforts, we saw a significant improvement in direct and overall gross margins beginning in the first quarter of 2007. With reduced inventory levels, we have excess warehouse capacity, and therefore we have begun reducing our warehouse space, and the related costs, which will assist in our efforts to further improve our direct gross margins.

Commentary Contribution and Contribution Margin. Contribution is defined as gross profit dollars less sales and marketing expense. Although sales were down 11%, we were able to increase contribution dollars by \$2.9 million (or 26%) to \$14.0 million this year versus \$11.1 million recorded during the same quarter in 2006. This was due to the improvements we made in gross margins (up 270 basis points to 16.0%) and a \$1.4 million reduction in sales and marketing dollars spent. This equates to contribution margin of 8.9% this year versus 6.2% in 2006. Our long-term goal is to achieve a 15% contribution margin.

Commentary Technology and G&A costs. With revenue declining, we have begun efforts to decrease our operating expenses. We have reduced our headcount from 864 at December 2006 to 698 at the end of March 2007. We terminated a long-term computer co-location facility lease in December 2006. We are in the process of significantly reducing additional facilities and warehouse lease costs and other expenses, including the reduction of space in our corporate offices. Although our combined technology and G&A costs in the first quarter were up slightly year-over-year, we expect these costs to decrease overall in 2007.

Commentary Balance Sheet Items. We ended the first quarter with just under \$17 million of inventory, significantly lower than the \$81 million of inventory we had at the end of the first quarter of 2006, and down from \$20 million at the end of 2006. From this lower inventory level, we were able to turn our inventory much more efficiently in the first quarter, while maintaining more attractive, higher margin products.

We ended the quarter with \$68 million in cash, and added \$11 million more in April as part of the proceeds from the sale of our OTravel subsidiary (see Financial Statements - Note 4). We anticipate that we will require less capital to run our business in the near future than we required in the recent past. However, whether we will need to raise additional capital will depend on, among other things, our revenues, gross margins, product sales mix and expenses.

The balance of our Management's Discussion and Analysis of Financial Condition and Results of Operations provides further information about the matters discussed above and other important matters affecting our business.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are as follows:

- revenue recognition;
- estimating valuation allowances and accrued liabilities, specifically, the reserve for returns, the allowance for doubtful accounts and the reserve for obsolete and damaged inventory;
- internal use software;

- accounting for income taxes;
- valuation of long-lived and intangible assets and goodwill; and
- stock based compensation and performance share plan.

Revenue recognition. We derive our revenue primarily from two sources: (i) direct revenue, which consists of merchandise sales made to consumers and businesses that are fulfilled from our warehouses; and (ii) fulfillment partner revenue, which consists of revenue from the sale of merchandise supplied and shipped by fulfillment partners directly to consumers and other businesses. This also includes listing fees and commissions collected from products being listed and sold through the Auctions tab of our Website as well as advertisement revenue derived from our cars listing business. All sources of revenue are recorded net of returns, coupons redeemed by customers, and other discounts. Revenues from our auction services and cars listing business were not material during the three months ended March 31, 2006 and 2007, and therefore are included in fulfillment partner revenue.

We record revenue from the majority of these sales transactions involving our fulfillment partners (excluding auctions) on

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a gross basis. Similar to our direct revenue segment, fulfillment partner products are available to both consumers and businesses.

For sales transactions, we comply with the provisions of Staff Accounting Bulletin 104 *Revenue Recognition*, which states that revenue should be recognized when the following revenue recognition criteria are met: (1) persuasive evidence of an arrangement exists; (2) the product has been shipped or the service provided and the customer takes ownership and assumes the risk of loss; (3) the selling price is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. We generally require payment by credit card at the point of sale. Amounts received prior to when we ship the goods or provide the services to customers are recorded as deferred revenue. In addition, amounts received in advance for gift cards, Club O memberships and marketing royalties related to our co-branded credit card program are recorded as deferred revenue and recognized in the period earned.

Reserve for returns, allowance for doubtful accounts and the reserve for obsolete and damaged inventory. Our management must make estimates of potential future product returns related to current period revenue. Management analyzes historical returns, current economic trends and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns reserve and other allowances in any accounting period. The reserve for returns was \$3.6 million and \$1.3 million as of December 31, 2006 and March 31, 2007, respectively.

From time to time, we may grant credit to certain of our business customers on normal credit terms (typically 30 days). We perform ongoing credit evaluations of our customers' financial condition and maintain an allowance for doubtful accounts receivable based upon our historical collection experience and expected collectibility of all accounts receivable. We maintained an allowance for doubtful accounts receivable of \$2.1 million and \$1.8 million as of December 31, 2006 and March 31, 2007, respectively.

We write down our inventory for estimated obsolescence or damage equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Once established, the original cost of the inventory less the related inventory reserve represents the new cost basis of such products. Reversal of these reserves is recognized only when the related inventory has been sold or scrapped. At December 31, 2006, our inventory balance was \$20.3 million, net of allowance for obsolescence or damaged inventory of \$6.6 million. At March 31, 2007, our inventory balance was \$16.7 million, net of allowance for obsolescence or damaged inventory of \$6.5 million.

Internal-Use Software and Website Development. Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our websites and processes supporting our business. As required by Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, we capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During the three months ended March 31, 2006 and 2007, we capitalized \$8.1 million and \$1.3 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$559,000 and \$776,000 for those respective periods.

Accounting for income taxes. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. As of December 31, 2006 and March 31, 2007, we have recorded a full valuation allowance of \$74.4 million and \$81.1 million, respectively, against our net deferred tax asset balance due to uncertainties related to our deferred tax assets as a result of our history of operating losses. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to change the valuation allowance, which could materially impact our financial position and results of operations.

Valuation of long-lived and intangible assets and goodwill. Under SFAS 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but must be tested for impairment at least annually. Other long-lived assets must also be evaluated for impairment when management believes that an asset has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses

or an inability to recover the carrying value of the asset that may not be reflected in an asset's current carrying value, thereby possibly requiring an impairment charge in the future. Goodwill totaled \$2.8 million as of December 31, 2006 and March 31, 2007.

In conjunction with the decision to sell OTravel, our travel subsidiary, we performed an evaluation of its goodwill, pursuant to SFAS 144, *Accounting for the Impairment Long-Lived Assets*, and SFAS 142, *Goodwill and Other Intangible Assets*, and determined that goodwill was subject to an impairment loss of approximately \$4.5 million during year ended December 31, 2006 and \$3.8 million during the three months ended March 31, 2007 (see Financial Statements Note 4 - Discontinued Operations). These have been recorded as a component of the loss from discontinued operations.

Stock-based compensation. As of January 1, 2006, we adopted SFAS 123(R), which requires us to measure compensation cost for all outstanding unvested share-based awards at fair value and recognize compensation over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates. We have utilized a Black-Scholes-Merton valuation model to estimate the value of stock options granted to employees. Several of the primary estimates used in measuring stock-based compensation are as follows:

Expected Volatility: The fair value of stock options were valued using a volatility factor based on the Company's historical stock prices.

Expected Term: The Company's expected term represents the period that the Company's stock options are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms and vesting provisions of the stock-based awards.

Expected Dividend: The Company has not paid any dividends and does not anticipate paying dividends in the foreseeable future.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used on the implied yield currently available on U.S. Treasury zero-coupon issues with remaining term equivalent to the expected term of the options.

Estimated Pre-vesting Forfeitures: When estimating forfeitures, the Company considers voluntary and involuntary termination behavior.

Performance Share Plan. In January 2006 the Board and Compensation Committee adopted the Overstock.com Performance Share Plan, and approved grants to executive officers and certain employees of the Company. The Performance Share Plan provides for a three-year period for the measurement of the Company's attainment of certain performance goals, but at the Company's sole option the Company may make a payment of estimated amounts payable to a plan participant after two years.

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of the Company's common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan will be payable in cash. During interim and annual periods prior to the completion of the three-year measurement period, we record compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates include assumed future growth rates in revenues, gross margins and other factors. If we were to use different assumptions, the estimated compensation charges could be significantly different.

Approximately \$400,000 and \$250,000 of compensation expense under the plan has been included in general and administrative expenses for the quarters ended March 31, 2006 and 2007, respectively. As of March 31, 2007, we have accrued \$1.2 million in total compensation expense under the plan.

Recent Accounting Pronouncements.

In March 2006, the Emerging Issue Task Force reached a consensus on Issue No. 06-03 *How Taxes Collected from Customers and Remitted to Government Authorities Should be Presented in the Income Statement (That Is, Gross versus Net Presentation)* (EITF No. 06-03). We adopted the provisions of EITF No. 06-03 beginning January 1, 2007. The adoption of EITF No. 06-03 did not have a material impact on our consolidated financial position, results of operations or cash flows.

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In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return.

We adopted the provisions of FIN 48, on January 1, 2007. As a result of a full valuation allowance, we do not have any unrecognized tax benefits and there is no effect on our financial condition or results of operations as a result of implementing FIN 48. We are subject to audit by the IRS and various states for the prior 3 years. We do not believe there will be any material changes in its unrecognized tax positions over the next 12 months. Our policy is that we recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of FIN 48, we did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the quarter ended March 31, 2007.

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We recognized no income tax benefit from the net loss generated in the three months ended March 31, 2006 and 2007. Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, requires that a valuation allowance be provided if it is more likely than not that some portion or all of a deferred tax asset will not be realized. Our ability to realize the benefit of its deferred tax asset will depend on the generation of future taxable income through profitable operations. As of March 31, 2007, we have established a full valuation allowance against its deferred tax assets.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of this standard apply to other accounting pronouncements that require or permit fair value measurements. We will adopt SFAS 157 on January 1, 2008. We anticipate that the adoption of SFAS 157 will not have a material impact on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, or SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for our fiscal year beginning January 1, 2008. We anticipate that the adoption of SFAS No. 159 will not have a material impact on our consolidated financial statements.

Results of Operations

The following table sets forth our results of operations expressed as a percentage of total revenue for the three months ended March 31, 2006 and 2007.

	Three months ended March 31,			
	2006		2007	
	(as a percentage of total revenue)			
Revenue				
Direct revenue	44.8	%	28.9	%
Fulfillment partner revenue	55.2		71.1	
Total revenue	100.0		100.0	
Cost of goods sold				
Direct	39.7		24.9	
Fulfillment partner	47.0		59.1	
Total cost of goods sold	86.7		84.0	
Gross profit	13.3		16.0	
Operating expenses:				
Sales and marketing	7.1		7.1	
Technology	7.5		9.5	
General and administrative	6.7		6.8	
Restructuring			3.8	
Total operating expenses	21.3		27.2	
Operating loss	(8.0)	(11.2)
Interest income, net	0.2		0.6	
Interest expense	(0.7)	(0.6)
Other (expense) income, net				
Loss from continuing operations	(8.5)%	(11.2)%

Comparison of Three Months Ended March 31, 2006 and 2007

Revenue

During the three months ended March 31, 2006 and 2007, total revenue decreased 11%, from \$178.0 million in 2006 to \$157.9 million in 2007. During the same period, direct revenue decreased 43%, from \$79.7 million in 2006 to \$45.7 million in 2007, while fulfillment partner revenue experienced 14% growth, from \$98.3 million in 2006 to \$112.2 million in 2007. We believe that the decrease in total revenue is primarily the result of a reduction in traffic to the Website due to a significant reduction in marketing expenditures as a percent of sales in the quarter (7.1%) compared to the previous two quarters (11.0% and 9.8%, respectively). In addition, because we have been able to significantly decrease our inventory over the past twelve months (from \$81 million at the end of Q1 2006 compared to less than \$17 million this year), our sales mix has

shifted more to our fulfillment partner business.

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We believe that the keys to future revenue growth are to increase our Website conversion rate defined as the percentage of visitors to the website who make a purchase and to significantly increase the number of products available on our Website by increasing the number of fulfillment partners selling product on our site. The areas of our business that most directly affect conversion rate are personalization of the website, customer retention, e-mail marketing, and site design and layout. Within each of these areas, we have identified and made progress on initiatives that we believe can improve conversion, including outsourcing to third-party providers certain aspects of the functionality on the website, including the engine that provides product recommendations to customers visiting product pages and the gift center on our Website. To significantly increase the product offering available for our customers, we are in the process of integrating with a third-party provider that will provide the technology to give additional fulfillment partners the ability to sell product on our site.

Gross Margin

Total Gross Margin For the three months ended March 31, 2006 and 2007, total cost of goods sold decreased \$21.7 million or 14%, from \$154.3 million in 2006 to \$132.6 in 2007, resulting in a 7% increase in gross profits (from \$23.8 million in 2006 to \$25.3 million in 2007). As a percent of total revenue, cost of goods sold decreased from 87% to 84% for those respective periods, resulting in increased gross margins of 13.3% and 16.0% for the three months ended March 31, 2006 and 2007, respectively.

Cost of goods sold also included stock-based compensation related to the adoption of SFAS 123(R) of \$96,000 and \$107,000 during the three months ended March 31, 2006 and 2007, respectively.

Generally, our overall gross margins fluctuate based on several factors, including our product mix of sales; sales volumes mix by our direct business and fulfillment partners; changes in vendor pricing; lowering prices for customers, including competitive pricing and inventory management decisions within the direct business; warehouse management costs; customer service costs; and our discounted shipping offers. Discounted shipping offers reduce shipping revenue, and therefore reduce our gross margins on retail sales.

Direct Gross Margins For the three months ended March 31, 2006 and 2007, gross profits for our direct business decreased 29% from \$9.0 million in 2006 to \$6.4 million in 2007. However, gross margins for our direct business increased from 11.2% to 13.9% for those respective periods. The lower gross profits are the result of direct revenue being down 43% from last year, primarily due to a significant reduction in direct inventory. However, gross margins have increased at the same time, since the remaining inventory in general turns faster and has higher profitability.

Fulfillment Partner Gross Margins For the three months ended March 31, 2006 and 2007, our fulfillment partner business generated gross profits of \$14.7 million and \$18.9 million, respectively, an increase of 28%. This increase in gross profit dollars is the result of the 14% increase in fulfillment partner sales combined with increased gross margins, from 15.0% to 16.8% for those respective periods. The increase in partner gross margins is the result of better product pricing and improvements in the cost of operations, including customer service.

Fulfillment costs

Fulfillment costs include all warehousing costs, including fixed overhead and variable handling costs (excluding packaging costs), as well as credit card fees and customer service costs, all of which we include as costs in calculating gross margins. We believe that some companies in our industry, including some of our competitors, account for fulfillment costs within operating expenses, and therefore exclude fulfillment costs from gross margins. As a result, our gross margins may not be directly comparable to others in our industry.

The following table has been included to provide investors additional information regarding our classification of fulfillment costs and gross margins, thus enabling investors to better compare our gross margins with others in our industry:

	Three months ended March 31,					
	2006			2007		
Total revenue	\$ 178,044	100	%	\$ 157,930	100	%
Cost of goods sold						
Product costs and other cost of goods sold	138,065	78	%	121,532	77	%
Fulfillment costs	16,225	9	%	11,083	7	%
Total cost of goods sold	154,290	87	%	132,615	84	%
Gross profit	\$ 23,754	13	%	\$ 25,315	16	%

As displayed in the above table, fulfillment costs during the three months ended March 31, 2006 and 2007 were \$16.2 million and \$11.1 million, respectively, or 9.1% and 7.0% of total revenue for those respective periods. Fulfillment costs as a percentage of sales may vary due to several factors, such as our ability to manage costs at our warehouses, significant changes in the number of units received and fulfilled, the extent we

utilize third party fulfillment services and warehouses, and our ability to effectively manage customer service costs and credit card fees.

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Operating expenses

Sales and marketing. For the three months ended March 31, 2006 and 2007, sales and marketing expenses totaled \$12.7 million and \$11.3 million (11% decrease), respectively. Our marketing expense is variable and is measured as a percentage of overall revenue. Sales and marketing expenses were flat year-over-year as a percentage of sales at 7%. We direct customers to our Websites primarily through a number of targeted online marketing channels, such as sponsored search, affiliate marketing, portal advertising, e-mail campaigns, and other initiatives. We also utilize channels such as nation-wide television, print and radio advertising campaigns.

While costs associated with our discounted shipping promotions are not included in marketing expense (they are accounted for as a reduction of revenue), we consider discounted shipping promotions as an effective marketing tool, and intend to continue to offer them as we deem appropriate.

Sales and marketing expenses also included stock-based compensation related to the adoption of SFAS 123(R) in 2006 of \$70,000 and \$78,000 during the three months ended March 31, 2006 and 2007, respectively.

Technology expenses. Technology expenses increased 12%, from \$13.4 million for the three months ended March 31, 2006, to \$15.0 million for the same period in 2007, representing 8% and 10% of total revenue for those respective periods. Technology expenses also included stock-based compensation related to the adoption of SFAS 123(R) in 2006 of \$159,000 and \$177,000 during the three months ended March 31, 2006 and 2007, respectively.

The year-over-year increase in technology expenses relates to increased depreciation expense. Although these costs are up from the first quarter of last year, we believe that they have now stabilized, and expect them to begin to decrease in 2008 as depreciation expense goes down.

General and administrative expenses. General and administrative (G&A) expenses decreased 10%, from \$11.9 million to \$10.7 million during the three months ended March 31, 2006 and 2007, respectively, representing approximately 7% of total revenue for each of the respective periods. We incurred stock-based compensation within general and administrative expenses of approximately \$633,000 and \$711,000 for the three months ended March 31, 2006 and 2007, respectively. The decrease in G&A expenses this quarter relates to decreases in payroll-related expenses, professional fees, merchandising, legal and finance costs as we have made reductions to our corporate headcount over the past six months.

A large portion of our technology and general and administrative expenses are non-cash expenses. Total depreciation and amortization (including amortization of stock-based compensation) during the first quarter of 2007 was \$8.9 million, and we estimate that total depreciation and amortization in 2007 will be approximately \$35 - \$40 million. This compares to similar non-cash depreciation and amortization expense of \$8.8 million for the three months ended March 31, 2006.

Restructuring expenses. During the fourth quarter of 2006, we commenced implementation of a facilities consolidation and restructuring program designed to reduce our overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program should be substantially completed during calendar year 2007 (see Financial Statements Note 3 Restructuring Expenses).

In the first quarter of 2007, we terminated a logistics services agreement and gave notice of our intent to sublease vacated warehouse facilities in Indiana and accrued \$4.6 million of charges. We also recorded an additional \$954,000 of restructuring charges related to accelerated amortization of leasehold improvements in our current corporate office facilities that we are attempting to sublease, and \$487,000 of other miscellaneous restructuring charges, including costs related to the reduction of data center space and corporate headcount.

Non-operating income (expense)

Interest income, interest expense and other income (expense). Interest income derived from the investment of our excess cash in short-term investments was \$315,000 and \$990,000 for the three months ended March 31, 2006 and 2007, respectively. This is due to both an increase in total cash and in interest rates in 2007 from 2006.

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Interest expense is largely related to our convertible notes, capital leases and our credit lines. Interest expense decreased slightly from \$1.3 million during the three months ended March 31, 2006 to \$1.0 million during the same period in 2007. The decrease in interest expense is due to the fact that we had \$20 million of borrowings outstanding on our inventory line of credit in the first quarter of 2006, and no borrowings outstanding during the same period in 2007.

Under SFAS No. 133, the Foreign Notes were considered to be derivative financial instruments and were marked to market quarterly. Any unrealized gain or loss related to the changes in value of the conditional coupon was recorded in the income statement as a component of interest income or expense. Any unrealized gain or loss related to the changes in the value of the Notes was recorded as a component of other comprehensive income (loss). On April 26, 2006, we sold the Foreign Notes

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for \$49.5 million, resulting in the gain on the bond instrument of \$1.9 million (see Financial Statements Note 5 Marketable Securities).

Discontinued operations

As part of the program to reduce our expense structure and sell non-core businesses, we decided during the fourth quarter of 2006 to sell our travel subsidiary (OTravel). As a result, OTravel 's operations have been classified as a discontinued operation and therefore are not included in the results of continuing operations. The loss from discontinued operations for OTravel was \$779,000 and \$3.6 million for the three months ended March 31, 2006 and 2007, respectively.

In addition, we have classified \$15.0 million of assets and \$993,000 of liabilities as held for sale related to the management 's decision to market and sell the OTravel subsidiary. In conjunction with the discontinuance of OTravel, we performed an evaluation of the goodwill associated with the reporting unit pursuant to SFAS 142, and SFAS 144, *Accounting for the Impairment of Long-Lived Assets* and determined that goodwill of approximately \$4.5 million was impaired as of December 31, 2006 based on a non-binding letter of intent from a third party to purchase this business. On April 25, 2007, we completed the sale of OTravel for \$11.0 million of cash and \$6.0 million of notes. Based on the estimated fair value of the discounted cash flows of the net proceeds from the sale, we recorded an additional goodwill impairment of \$3.8 million as of March 31, 2007 (see Financial Statements Note 4 Discontinued Operations).

Income taxes

Income taxes. For the three months ended March 31, 2006 and 2007, we incurred net operating losses, and consequently paid insignificant amounts of federal, state and foreign income taxes. As of December 31, 2006 and March 31, 2007, we had net operating loss carryforwards of approximately \$145.2 million and \$166.7 million, respectively, which may be used to offset future taxable income. An additional \$15.9 million of net operating losses are limited under Internal Revenue Code Section 382 to \$799,000 a year. These net operating loss carryforwards will begin to expire in 2018.

Seasonality

Based upon the Company 's historical experience, increased revenues typically occur during the fourth quarter because of the Christmas retail season. The actual quarterly results for each quarter could differ materially depending upon consumer preferences, availability of product and competition, among other risks and uncertainties. Accordingly, there can be no assurances that seasonal variations will not materially affect the Company 's results of operations in the future. The following table reflects the Company 's revenues for each of the quarters since 2004 (in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2007	\$ 157,930			
2006	178,044	\$ 159,192	\$ 156,885	\$ 294,029
2005	165,881	150,638	167,779	315,018
2004	82,078	87,792	103,444	221,321

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company 's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that would be material to investors.

Liquidity and Capital Resources

Prior to the second quarter of 2002, we financed our activities primarily through a series of private sales of equity securities, warrants to purchase our common stock and promissory notes. During the second quarter of 2002, we completed our initial public offering pursuant to which we received approximately \$26.1 million in cash, net of underwriting discounts, commissions, and other related expenses. Additionally, we completed follow-on offerings in February 2003, May 2004 and November 2004, pursuant to which we received approximately \$24.0 million, \$37.9 million and \$75.2 million, respectively, in cash, net of underwriting discounts, commissions, and other related expenses. In November 2004, we also received \$116.2 million in proceeds from the issuance of our convertible senior notes in a transaction event exempt from registration under the Securities Act. During 2006, we received \$64.4 million from two stock offerings in May and December. At March

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31, 2007, our cash and cash equivalents balance was \$68.1 million.

Our operating activities resulted in net cash outflows of \$72.6 million and \$58.2 million for the three months ended March 31, 2006 and 2007, respectively. We have payment terms with our fulfillment partners that extend beyond the amount of time necessary to collect proceeds from our customers. As a result, following our seasonally strong fourth quarter sales, at

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December 31 of each year, our cash, cash equivalents, marketable securities and accounts payable balances typically reach their highest level (other than as a result of cash flows provided by or used in investing and financing activities). However, our accounts payable balance normally declines during the first three months following year-end, which normally results in a decline in our cash, cash equivalents, and marketable securities balances in the first quarter each year.

The primary use of cash and cash equivalents during the three months ended March 31, 2006 was to fund our operations, including net losses of \$15.9 million (which includes \$779,000 of loss from discontinued operations and \$8.1 million of other net non-cash activity), as well as changes in prepaid expenses, accounts payables and accrued liabilities of \$1.9 million, \$63.6 million and \$15.2 million, respectively. This was offset by the cash provided from changes in accounts receivable, inventory, prepaid inventory and other long-term assets of \$2.3 million, \$11.9 million, \$794,000 and \$47,000, respectively. For the three months ended March 31, 2007, the primary use of cash and cash equivalents was to fund our operations, including net losses of \$21.4 million (which includes \$3.6 million of loss from discontinued operations, \$6.1 million of non-cash restructuring costs and \$9.5 million of other net non-cash activity), as well as changes in prepaid inventory, prepaid expenses, accounts payables and accrued liabilities of \$360,000, \$2.0 million, \$38.1 million and \$23.3 million, respectively. This was offset by the cash provided from changes in accounts receivable, inventory and other long-term assets of \$3.8 million, \$3.6 million and \$90,000, respectively.

Investing activities resulted in cash inflows of \$575,000 and \$3.5 million for the three months ended March 31, 2006 and 2007, respectively. The cash inflows from investing activities in 2006 primarily resulted from the sale of marketable securities of \$7.3 million, offset by expenditures for property and equipment of \$6.8 million. Cash inflows from investing activities in 2007 resulted from cash received from the payments totaling \$3.9 million on a note receivable given in consideration for our variable interest entity, offset by expenditures for property and equipment of \$447,000.

Financing activities resulted in cash inflows of \$18.6 million and cash outflows of \$4.1 million during the three months ended March 31, 2006 and 2007, respectively. The cash inflow of \$18.6 million in 2006 was primarily the result of net cash received from net borrowings on our inventory line of credit of \$20.0 million and cash received from the exercise of stock options and warrants. Cash outflow for financing activities in 2007 was primarily from capital lease payments of \$5.2 million, offset by \$1.2 million of proceeds from the exercise of stock options.

Certain prior-year amounts have been reclassified to conform to the current year's financial statement presentation. In addition, we have revised our consolidated statements of cash flows for the year ended December 31, 2006 to present the operating and investing portion of the cash flows attributable to discontinued operations on a separately identifiable basis.

While we believe that the cash and marketable securities currently on hand, amounts available under our credit facility and expected cash flows from future operations will be sufficient to continue operations for at least the next twelve months, we may require additional financing. However, there can be no assurance that if additional financing is necessary it will be available, or, if available, that such financing can be obtained on satisfactory terms. Failure to generate sufficient revenues, generate profitability or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives. Any projections of future cash needs and cash flows are subject to substantial uncertainty.

Contractual Obligations and Commitments. The following table summarizes our contractual obligations as of March 31, 2007 and the effect such obligations and commitments are expected to have on our liquidity and cash flow in future periods:

Payments Due by Period