PFSWEB INC
Form 10-Q
August 14, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended June 30, 2007

OR

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

For the Transition Period from __________ to __________

Commission File Number 000-28275

PFSweb, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-2837058**
(State of Incorporation)	(I.R.S. Employer I.D. No.)
500 North Central Expressway, Plano, Texas	**75074**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(972) 881-2900**

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

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

At August 7, 2007 there were 46,563,008 shares of registrant s common stock outstanding.

PFSWEB, INC. AND SUBSIDIARIES
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PART I. FINANCIAL INFORMATION
ITEM 1. Financial Statements

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	June 30, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 15,088	$ 15,066
Restricted cash	1,838	2,653
Accounts receivable, net of allowance for doubtful accounts of $1,891 and $2,352 at June 30, 2007 and December 31, 2006, respectively	48,251	49,186
Inventories, net of reserves of $2,176 and $2,987 at June 30, 2007 and December 31, 2006, respectively	44,631	47,670
Other receivables	10,902	10,774
Prepaid expenses and other current assets	3,449	3,531
Total current assets	124,159	128,880
PROPERTY AND EQUIPMENT, net	12,119	12,884
IDENTIFIABLE INTANGIBLES	6,227	6,647
GOODWILL	15,362	15,362
OTHER ASSETS	840	848
Total assets	$ 158,707	$ 164,621
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 28,533	$ 23,802
Trade accounts payable	56,337	62,441
Accrued expenses	22,325	21,485
Total current liabilities	107,195	107,728
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	2,653	6,076
OTHER LIABILITIES	1,828	1,977
Total liabilities	111,676	115,781

COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued and outstanding	¾	¾
Common stock, $0.001 par value; 75,000,000 shares authorized; 46,563,008 and 46,553,752 shares issued at June 30, 2007 and December 31, 2006, respectively; and 46,476,708 and 46,467,452 outstanding at June 30, 2007 and December 31, 2006, respectively	47	47
Additional paid-in capital	91,699	91,302
Accumulated deficit	(46,561)	(44,354)
Accumulated other comprehensive income	1,931	1,930
Treasury stock at cost, 86,300 shares	(85)	(85)
Total shareholders equity	47,031	48,840
Total liabilities and shareholders equity	$ 158,707	$ 164,621

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

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
REVENUES:				
Product revenue, net	$ 84,678	$ 89,650	$ 165,135	$ 179,854
Service fee revenue	17,646	16,209	34,608	32,128
Pass-through revenue	6,076	3,445	13,064	7,990
Total net revenues	108,400	109,304	212,807	219,972
COSTS OF REVENUES:				
Cost of product revenue	77,798	84,486	152,569	168,809
Cost of service fee revenue	12,635	11,366	25,299	22,745
Pass-through cost of revenue	6,076	3,445	13,064	7,990
Total costs of revenues	96,509	99,297	190,932	199,544
Gross profit	11,891	10,007	21,875	20,428
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	10,427	11,637	21,419	22,429
STOCK BASED COMPENSATION	188	241	397	480
MERGER INTEGRATION EXPENSE		449	150	642
AMORTIZATION OF IDENTIFIABLE INTANGIBLES	204	204	408	341
Total operating expenses	10,819	12,531	22,374	23,892
Income (loss) from operations	1,072	(2,524)	(499)	(3,464)
INTEREST EXPENSE, NET	658	517	1,242	948
Income (loss) before income taxes	414	(3,041)	(1,741)	(4,412)
INCOME TAX EXPENSE, NET	260	143	466	359
NET INCOME (LOSS)	$ 154	$ (3,184)	$ (2,207)	$ (4,771)
NET INCOME (LOSS) PER SHARE:				
Basic	$ 0.00	$ (0.07)	$ (0.05)	$ (0.12)
Diluted	$ 0.00	$ (0.07)	$ (0.05)	$ (0.12)

WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	46,477	43,072	46,476	39,011
Diluted	47,011	43,072	46,476	39,011

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

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,207)	$ (4,771)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	4,088	3,589
Loss on disposal of assets		143
Provision for doubtful accounts	168	275
Provision for excess and obsolete inventory	341	452
Deferred income taxes	47	(24)
Stock-based compensation	397	480
Changes in operating assets and liabilities:		
Restricted cash	(602)	879
Accounts receivable	1,113	2,216
Inventories, net	3,106	(6,217)
Prepaid expenses, other receivables and other assets	96	975
Accounts payable, accrued expenses and other liabilities	(6,153)	3,030
Net cash provided by operating activities	394	1,027
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(1,991)	(2,123)
Payment for purchase of eCOST, net of cash acquired		(1,299)
Decrease in restricted cash	146	748
Net cash used in investing activities	(1,845)	(2,674)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on capital lease obligations	(1,006)	(692)
Decrease in restricted cash	1,269	247
Proceeds from issuance of common stock	9	4,888
Proceeds from debt, net	1,489	1,210
Net cash provided by financing activities	1,761	5,653
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(288)	(136)
NET INCREASE IN CASH AND CASH EQUIVALENTS	22	3,870
CASH AND CASH EQUIVALENTS, beginning of period	15,066	13,683

CASH AND CASH EQUIVALENTS, end of period	$ 15,088	$ 17,553
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under capital leases	$ 1,365	$ 708
Share consideration to acquire eCOST	$	$ 26,778

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

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PFweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries, including Supplies Distributors, Inc., and eCOST.com, Inc., are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; eCOST refers to eCOST.com, Inc.; and PFSweb refers to PFSweb, Inc. and its subsidiaries excluding Supplies Distributors and eCOST.

PFSweb Overview

PFSweb is an international provider of integrated business process outsourcing services to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional and e-commerce initiatives in the United States, Canada, and Europe. PFSweb offers such services as professional consulting, technology collaboration, managed web hosting and internet application development, order management, web-enabled customer contact centers, customer relationship management, financial services including billing and collection services and working capital solutions, information management, facilities and operations management, kitting and assembly services, and international fulfillment and distribution services.

Supplies Distributors Overview

Supplies Distributors, PFSweb and International Business Machines Corporation (IBM) have entered into master distributor agreements whereby Supplies Distributors acts as a master distributor of various products, primarily IBM product. Pursuant to transaction management services agreements between PFSweb and Supplies Distributors, PFSweb provides transaction management and fulfillment services to Supplies Distributors.

Supplies Distributors has obtained certain financing that allows it to fund the working capital requirements for the sale of primarily IBM products. Pursuant to the transaction management services agreements, PFSweb provides to Supplies Distributors such services as managed web hosting and maintenance, procurement support, web-enabled customer contact center services, customer relationship management, financial services including billing and collection services, information management, and international distribution services. Additionally, IBM and Supplies Distributors have outsourced the product demand generation to a third party. Supplies Distributors sells its products in the United States, Canada and Europe.

All of the agreements between PFSweb and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFSweb s and Supplies Distributors arrangement with IBM. Although management believes that the terms of these agreements are generally consistent with fair market values, there can be no assurance that the prices charged to or by each company under these arrangements are not higher or lower than the prices that may be charged by, or to, unaffiliated third parties for similar services.

eCOST Overview

eCOST is a multi-category online discount retailer of new, close-out and recertified brand-name merchandise, selling products primarily to customers in the United States. eCOST offers products in several merchandise categories, including computer hardware and software, home electronics, digital imaging, watches and jewelry, housewares, DVD movies, video games and cellular/wireless. eCOST carries products from leading manufacturers such as Apple, Canon, Citizen, Denon, Hewlett-Packard, Nikon, Onkyo, Seiko and Toshiba.

The Company s liquidity has been negatively impacted as a result of the merger with eCOST. During the six months ended June 30, 2007 and the year ended December 31, 2006, eCOST experienced a net usage of cash primarily due to losses incurred. As a result, during the process of transitioning and integrating eCOST s operations, the Company has had to support eCOST s cash needs with the goal of

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

achieving a stabilized operational position. The amount of further cash needed to support eCOST operations will depend upon the financing available as well as eCOST s continued ability to improve its financial results.

In the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

Management currently believes eCOST will meet the Company s expectations related to annual savings and overall profitability. If eCOST does not meet these expectations, the Company anticipates that it would be able to terminate or sublease eCOST s facility leases, liquidate remaining inventory through the eCOST website and reduce personnel related costs as needed to maintain profitability among the Company s other segments.

The Company expects further improvement in eCOST s financial results in 2007 and beyond as a result of continued efforts to increase sales, improve product mix and control operating costs, although there can be no assurance that these improvements will be achieved.

Acquisition of eCOST

Effective February 1, 2006, a wholly-owned subsidiary of PFSweb merged with and into eCOST, with eCOST surviving the merger as a wholly-owned subsidiary of PFSweb. As a result of the merger, effective February 1, 2006, the Company began consolidating 100% of eCOST s financial position and results of operations into the Company s consolidated financial statements. The following table presents selected pro forma information, for comparative purposes, assuming the acquisition had occurred on January 1 for the period presented (unaudited) (in thousands):

	Six Months Ended June 30, 2006
Net revenues	$ 232,906
Net loss	(6,361)
Basic and diluted loss per share	(0.16)

The unaudited pro forma information combines the historical unaudited consolidated statements of the Company s operations and eCOST s operations for the six months ended June 30, 2006 giving effect to the merger and related events as if they had been consummated on January 1 for the period presented. Pro forma adjustments have been made to reflect the amortization expense relating to the finite lives of certain acquired intangibles, such as trademark name and customer relationships.

The unaudited pro forma information does not reflect operational and administrative cost savings, which are referred to as synergies, that management believes have been achieved as a result of the merger transaction, or other incremental costs that may be incurred as a direct result of the merger transaction. The unaudited pro forma net revenue and pro forma net loss are not necessarily indicative of the consolidated results of operations for future periods or the results of operations that would have been realized had the Company consolidated eCOST during the period noted.

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of June 30, 2007, and for the three and six months ended June 30, 2007 and 2006, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim condensed consolidated financial statements of the Company include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the Company s financial position as of June 30, 2007, its results of operations for the three and six months ended June 30, 2007 and 2006 and its cash flows for the six months ended June 30, 2007 and 2006. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

Certain prior period data has been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net loss or shareholders equity.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. The recognition and allocation of certain revenues and operating expenses in these consolidated financial statements also require management estimates and assumptions. The Company s estimates and assumptions are continually evaluated based on available information and experience. Because the use of estimates is inherent in the financial reporting process, actual results could differ from estimates.

Investment in Affiliates

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has made advances to Supplies Distributors which are evidenced by a Subordinated Demand Note (the Subordinated Note). Under the terms of certain of the Company s debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than $8.0 million or decreased to lower than $6.0 million without prior approval of the Company s lenders. As of June 30, 2007, the outstanding balance of the Subordinated Note was $6.0 million. The Subordinated Note is eliminated in the Company s consolidated financial statements.

PFS has also made advances to eCOST which aggregated $6.9 million as of June 30, 2007. Certain of the Company s debt facilities provide that the total advances to eCOST may not be less than $2.0 million without prior approval of eCOST s lender or increased above $8.5 million without the approval of PFS lender. PFSweb has also advanced to eCOST $4.7 million as of June 30, 2007.

Concentration of Business and Credit Risk

The Company s service fee revenue is generated under contractual service fee relationships with multiple client relationships. No customers exceeded 10% of consolidated revenue during the six months ended June 30, 2007. A summary of the customer and client concentrations is as follows:

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PFSweb, Inc. and Subsidiaries
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	Six Months Ended	
	June 30, 2007	June 30, 2006
Product Revenue (as a percentage of Product Revenue):		
Customer 1	9%	11%
Service Fee Revenue (as a percentage of Service Fee Revenue):		
Client 1	25%	25%
Client 2	13%	19%
Client 3	11%	12%
Accounts Receivable:		
Client/Customer 1	13%	13%
Client/Customer 2	10%	9%

PFSweb has provided certain collateralized guarantees of its subsidiaries financings and credit arrangements. These subsidiaries ability to obtain financing on similar terms would be significantly impacted without these guarantees. Additionally, since Supplies Distributors has limited personnel and physical resources, its ability to conduct business could be materially impacted by any termination of its contract with the party performing product demand generation for the IBM products sold by Supplies Distributors.

The Company has multiple arrangements with IBM and is dependent upon the continuation of such arrangements. These arrangements, which are critical to the Company s ongoing operations, include Supplies Distributors master distributor agreements, certain of Supplies Distributors working capital financing agreements, product sales to IBM business units and a term master lease agreement.

eCOST s arrangements with its vendors are terminable by either party at will. Loss of any vendors could have a material adverse effect on its financial position, results of operations and cash flows. Sales of HP and HP-related products represented 52% of eCOST s net revenues (12% of the Company s consolidated total net revenues) in the six months ended June 30, 2007. Sales of these products in the five month period ended June 30, 2006 were 31% and 7% of eCOST s net revenues and the Company s consolidated net revenues, respectively.

Inventories

The Company establishes inventory reserves based upon estimates of potential declines in values due to inventories that are slow moving or obsolete, excess levels of inventory or values assessed at lower than cost. Recoverability of the inventory on hand is measured by comparison of the carrying value of the inventory to the estimated fair value of the inventory.

Supplies Distributors assumes responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined. In the event PFSweb, Supplies Distributors and IBM terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors then existing inventory.

The allowance for slow moving inventory was $2.2 million and $3.0 million at June 30, 2007 and December 31, 2006, respectively.

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Property and Equipment

The Company s property held under capital leases amounted to approximately $3.7 million and $3.7 million, net of accumulated amortization of approximately $9.3 million and $10.0 million, at June 30, 2007 and December 31, 2006, respectively.

Long-Lived Assets

The Company reviews long-lived assets for impairment periodically, but at a minimum annually, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets include property, intangible assets, goodwill and certain other assets. Recoverability of assets is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value would be determined using appraisals, discounted cash flow analysis or similar valuation techniques. We make judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and amortization methods and useful lives. We record impairment losses in the period in which we determine that the carrying amount is not recoverable. This may require us to make judgments regarding long-term forecasts of our future revenues and costs related to the assets subject to review.

Stock-Based Compensation

During the six months ended June 30, 2007, the Company issued an aggregate of 608,000 options to purchase shares of common stock to officers, directors, employees and consultants of the Company.

Cash Paid During Year

The Company made payments for interest of approximately $1.4 million and $0.9 million and income taxes of approximately $1.1 million and $0.6 million during the six months ended June 30, 2007 and 2006, respectively.

Impact of Recently Issued Accounting Standards

In 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN 48), which prescribes accounting for and disclosure of uncertainty in tax positions. This interpretation defines the criteria that must be met for the benefits of a tax position to be recognized in the financial statements and the measurement of tax benefits recognized. Effective January 1, 2007, the Company adopted the provisions of FIN 48; however, there was no impact as a result of adopting such provisions and the amount of unrecognized tax benefits at adoption was insignificant. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense.

For federal income tax purposes, tax years that remain subject to examination include years 2003 to 2006. However, the utilization of net operating loss (NOL) carryforwards that arose prior to 2003 remain subject to examination through the years such carryforwards are utilized. For Europe, tax years that remain subject to examination include years 2004 to 2006. However, the utilization of NOL carryforwards that arose prior to 2004 remain subject to examination through the years such carryforwards are utilized. For Canada, tax years that remain subject to examination include years 1999 to 2006, depending on the subsidiary. For state income tax purposes, the tax years that remain subject to examination include years 2002 to 2006, depending upon the jurisdiction in which the Company files tax returns.

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

3. COMPREHENSIVE LOSS (in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income (loss)	$ 154	$ (3,184)	$ (2,207)	$ (4,771)
Other comprehensive loss:				
Foreign currency translation adjustment	(68)	348	(1)	551
Comprehensive income (loss)	$ 86	$ (2,836)	$ (2,208)	$ (4,220)

4. NET LOSS PER COMMON SHARE

Basic and diluted net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding for the reporting period. For the three and six months ended June 30, 2007, outstanding options of 2.6 million and 6.5 million, respectively, to purchase common shares were anti-dilutive and have been excluded from the weighted diluted average share computation. For the three and six months ended June 30, 2006, outstanding options of 6.1 million to purchase common shares were antidilutive and have been excluded from the weighted diluted average share computation. Warrants not included in the calculation of diluted net loss per share for the three and six months ended June 30, 2007 and 2006 were 0.6 million for each period.

5. VENDOR FINANCING:

Outstanding obligations under vendor financing arrangements consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Inventory and working capital financing agreements:		
United States	$ 24,166	$ 28,037
Europe	12,531	12,713
Total	$ 36,697	$ 40,750

Inventory and Working Capital Financing Agreement, United States

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of IBM products in the United States, providing financing for eligible IBM inventory and for certain receivables up to $30.5 million through its expiration in March 2008. As of June 30, 2007, Supplies Distributors had $1.6 million of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $6.0 million and a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (8.75% as of June 30, 2007). The facility also includes a monthly service fee. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. (IBM Belgium) to finance their distribution of IBM products in Europe. The asset based credit facility with IBM Belgium provides up to 12.5 million Euros (approximately $16.9 million) in financing for purchasing IBM inventory and for certain receivables

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

through its expiration in March 2008. As of June 30, 2007, Supplies Distributors European subsidiaries had 1.9 million euros ($2.6 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiaries to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors European subsidiaries, as well as collateralized guaranties of Supplies Distributors and PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $6.0 million and a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at Euribor plus 1.5% (5.5% as of June 30, 2007). Supplies Distributors European subsidiaries pay a monthly service fee on the commitment. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

7. *DEBT AND CAPITAL LEASE OBLIGATIONS;*

Outstanding obligations under debt and capital lease obligations consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Loan and security agreements, United States		
Supplies Distributors	$ 13,298	$ 12,102
PFS	7,292	6,985
Credit facility eCOST		
Factoring agreement, Europe	1,507	1,039
Taxable revenue bonds	4,000	4,500
Master lease agreements	4,596	4,742
Other	493	510
Total	31,186	29,878
Less current portion of long-term debt	28,533	23,802
Long-term debt, less current portion	$ 2,653	$ 6,076

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Wachovia Bank, N.A. (Wachovia) to provide financing for up to $25 million of eligible accounts receivable in the United States and Canada. As of June 30, 2007, Supplies Distributors had $1.5 million of available credit under this agreement. The Wachovia facility expires on the earlier of March 29, 2009 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement. Borrowings under the Wachovia facility accrue interest at prime rate or Eurodollar rate plus 1.75% to 2.25%, dependent on excess availability, as defined. The interest rate as of June 30, 2007 was 8.25% for $7.3 million of outstanding borrowings and 7.3% for $6.0 million of outstanding borrowings. This agreement contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than $5.5 million and restricted cash of less than $5.0 million, and is restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Wachovia pursuant to which a security interest was granted to Wachovia for all U.S. and Canadian customer remittances received in specified bank accounts. At June 30, 2007 and December 31, 2006, these

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

bank accounts held $1.0 million and $2.2 million, respectively, which was restricted for payment to Wachovia.

Loan and Security Agreement PFSweb

PFS has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to $10.0 million of eligible accounts receivable financing (Working Capital Advances) through April 2008, a Term Loan of $1.5 million due in monthly installments through December 2007 and $2.5 million of equipment financing (Equipment Advances) through June 15, 2008. Outstanding Working Capital Advances, $6.4 million as of June 30, 2007, accrue interest at prime rate plus 1% (9.25% as of June 30, 2007). Outstanding Equipment Advances, ($0.2 million as of June 30, 2007) and the Term Loan ($0.7 million outstanding as of June 30, 2007), accrue interest at prime rate plus 1.5% (9.75% as of June 30, 2007). As of June 30, 2007, PFS had $2.2 million of available credit under the Working Capital Advance portion of this facility and no available credit under the Equipment Advance or Term Loan portions of this facility. In July 2007, the Company repaid the $6.4 million of Working Capital Advances outstanding as of June 30, 2007. The Comerica Agreement contains cross default provisions, various restrictions upon PFS ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, a minimum earnings before interest and taxes, plus depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the subordinated note receivable from Supplies Distributors to a maximum of $8 million. Subject to certain restrictions, Comerica has provided approval for PFS to advance $8.5 million in cash to fund the cash flow requirements of eCOST, with certain restrictions, if needed, of which $6.9 million had been advanced as of June 30, 2007. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb, Inc.

Credit Facility eCOST

eCOST has an asset-based line of credit facility of up to $7.5 million from Wachovia Capital Finance Corporation (Western), through May 2009, which is collateralized by substantially all of eCOST s assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory. Outstanding amounts under the facility bear interest at rates ranging from the prime rate to the prime rate plus 0.5% (8.75% as of June 30, 2007), depending on eCOST s financial results. As of June 30, 2007, eCOST had $1.8 million of letters of credit outstanding and $1.2 million of available credit under this facility. In connection with the line of credit, eCOST entered into a cash management arrangement whereby eCOST s operating amounts are swept and used to repay outstanding amounts under the line of credit. The credit facility restricts eCOST s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth of $0 million, as defined. PFSweb has guaranteed all current and future obligations of eCOST under this line of credit.

Factoring Agreement

Supplies Distributors European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (Fortis) to provide factoring for up to 7.5 million euros (approximately $10.1 million) of eligible accounts receivables through March 2008. As of June 30, 2007, Supplies Distributors European subsidiary had approximately 2.3 million euros ($3.1 million) of available credit under this agreement. Borrowings accrue interest at Euribor plus 0.6% (4.7% at June 30, 2007). This agreement contains various restrictions upon the ability of Supplies Distributors European subsidiary to, among other things, merge, consolidate and incur indebtedness, as well as financial covenants, such as minimum net worth. This agreement is secured by a guarantee of Supplies Distributors, up to a maximum of 200,000 euros.

PFSweb, Inc. and Subsidiaries
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Taxable Revenue Bonds

PFSweb has a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) in connection with the issuance by the MBFC of $5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned the proceeds of the Bonds to PFSweb for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in the Company s Southaven, Mississippi distribution facility. The Bonds bear interest at a variable rate (5.4% as of June 30, 2007), as determined by Comerica Securities, as Remarketing Agent. PFSweb, at its option, may convert the Bonds to a fixed rate, to be determined by the Remarketing Agent at the time of conversion.

The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) in the initial face amount of $5.1 million issued by Comerica pursuant to a Reimbursement Agreement between PFSweb and Comerica under which PFSweb is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of April 2008 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. If the Letter of Credit is renewed or replaced, the Bonds require future principal repayments of $800,000 in each of January 2008 through 2012.

Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with its covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of shareholders equity or net worth, and one or all of the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. In particular, in the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit Corporation (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of 3 years. The outstanding leasing transactions ($1.0 million and $1.0 million as of June 30, 2007 and December 31, 2006, respectively) are secured by the related equipment.

The Company has two other master agreements with financing companies that provide for leasing or financing transactions of certain equipment. The amounts outstanding under these agreements were $1.7 million and $2.1 million as of June 30, 2007 and December 31, 2006, respectively, and are secured by the related equipment.

The Company has other leasing and financing agreements and will continue to enter into those arrangements as needed to finance the purchasing or leasing of certain equipment or other assets. Borrowings under these agreements are generally secured by the related equipment.

8. *SEGMENT INFORMATION*

The Company is organized into three operating segments: PFSweb is an international provider of integrated business process outsourcing solutions and operates as a service fee business; Supplies

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Distributors is a master distributor of primarily IBM products; and eCOST is a multi-category online discount retailer of new, close-out and recertified brand-name merchandise.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Revenues (in thousands):				
PFSweb	$ 25,831	$ 21,859	$ 51,915	$ 44,847
Supplies Distributors	57,595	60,867	116,405	129,282
eCOST	27,083	28,783	48,730	50,572
Eliminations	(2,109)	(2,205)	(4,243)	(4,729)
	$ 108,400	$ 109,304	$ 212,807	$ 219,972
Income (loss) from operations (in thousands):				
PFSweb	$ (162)	$ 220	$ (1,774)	$ (309)
Supplies Distributors	2,060	1,549	3,428	3,304
eCOST	(826)	(4,293)	(2,153)	(6,459)
Eliminations				
	$ 1,072	$ (2,524)	$ (499)	$ (3,464)
Depreciation and amortization (in thousands):				
PFSweb	$ 1,837	$ 1,545	$ 3,582	$ 3,106
Supplies Distributors	6	3	10	3
eCOST	251	289	496	480
Eliminations				
	$ 2,094	$ 1,837	$ 4,088	$ 3,589
Capital expenditures (in thousands):				
PFSweb	$ 1,111	$ 1,334	$ 1,849	$ 1,984
Supplies Distributors		11	7	45
eCOST	91	88	135	94
Eliminations				
	$ 1,202	$ 1,433	$ 1,991	$ 2,123

	June 30, 2007	December 31, 2006
Assets (in thousands):		
PFSweb	$ 97,549	$ 100,229
Supplies Distributors	83,208	85,249
eCOST	34,008	33,616
Eliminations	(56,058)	(54,473)

	$ 158,707	$ 164,621

9. *COMMITMENTS AND CONTENGENCIES*

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. In December 2006, the Company received notice that the municipal authority planned to make an adjustment to certain tax abatements. The Company plans to dispute the adjustment, but if the dispute is not resolved favorably, the Company could be assessed additional taxes from January 1, 2004. The Company has not accrued for the additional taxes, which through June 30, 2007 could be approximately $1.5 million, as it does not believe that it is probable that an additional assessment will be incurred.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek s Plan of Liquidation. The complaint alleged, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

was damaged thereby in the amount of at least $38 million. On May 3, 2007, the Court granted certain motions for summary judgment filed by the Company and certain of the former Daisytek directors. As a result of this ruling, all of the claims against the Company have been dismissed, although certain of the claims against certain of the individual defendants remain. Through June 30, 2007, the Company has incurred outstanding legal costs of $1.2 million, which have not been paid as the Company expects such costs to be covered by insurance. As of August 13, 2007, the insurance companies have paid approximately $1.0 million of the outstanding legal costs.

On July 12, 2004, eCOST received correspondence from MercExchange LLC alleging infringement of MercExchange s U.S. patents relating to e-commerce and offering to license its patent portfolio to eCOST. On July 15, 2004, eCOST received a follow-up letter from MercExchange specifying which of its technologies MercExchange believed infringed certain of its patents, alone or in combination with technologies provided by third parties. Some of those patents are currently being litigated by third parties, and eCOST is not involved in those proceedings. In addition, three of the four patents identified by MercExchange are under reexamination at the U.S. Patent and Trademark Office, which may or may not result in the modification of those claims. In the July 15 letter, MercExchange also advised eCOST that it has a number of applications pending for additional patents. MercExchange has filed lawsuits alleging infringement of some or all of its patents against third parties, resulting in settlements or verdicts in favor of MercExchange. At least one such verdict was appealed to the United States Court of Appeals for the Federal Circuit and was affirmed in part. Recently, the Supreme Court reversed the ruling by the United States Court of Appeals for the Federal Circuit Court requiring that an injunction must be issued in that case. Based on eCOST s investigation of this matter to date, eCOST believes that its current operations do not infringe any valid claims of the patents identified by MercExchange in these letters. There can be no assurance, however, that such claims will not be material or adversely affect eCOST s business, financial position, results of operations or cash flows.

On July 25, 2007 a purported class action lawsuit entitled *Darral Frank and Joseph F. Keeley, Jr.. v. PC Mall, Inc. dba eCOST.com and eCOST.com, Inc.* was filed in the Superior Court of California, Los Angeles County. The purported class consists of all of current and former sales representatives who worked for the defendants in California from July 24, 2003 through July 24, 2007. The lawsuit alleges that the defendants failed to pay overtime compensation and interest thereon, failed to timely pay compensation to terminated employees and failed to provide meal and rest periods, all in violation of the California Labor Code and Business and Professions Code. The complaint seeks unpaid overtime, statutory penalties, interest, attorneys fees, punitive damages, restitution and injunctive relief. The Company intends to vigorously contest this action and does not believe the claims have any merit.

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ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our results of operations and financial condition should be read in conjunction with the unaudited interim condensed consolidated financial statements and related notes appearing elsewhere in this Form 10-Q.

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like seek, strive, believe, expect, anticipate, predict, potential, continue, will, may, could, intend, plan, target and estimate or si are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K for the year ended December 31, 2006, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

- our ability to retain and expand relationships with existing clients and attract and implement new clients;
- our reliance on the fees generated by the transaction volume or product sales of our clients;
- our reliance on our clients projections or transaction volume or product sales;
- our dependence upon our agreements with IBM;
- our dependence upon our agreements with our major clients;
- our client mix, their business volumes and the seasonality of their business;
- our ability to finalize pending contracts;
- the impact of strategic alliances and acquisitions;
- trends in e-commerce, outsourcing, government regulation both foreign and domestic and the market for our services;
- whether we can continue and manage growth;
- increased competition;
- our ability to generate more revenue and achieve sustainable profitability;
- effects of changes in profit margins;
- the customer and supplier concentration of our business;
- the unknown effects of possible system failures and rapid changes in technology;
- foreign currency risks and other risks of operating in foreign countries;
- potential litigation;
- potential delisting;

our dependency on key personnel;

the impact of new accounting standards and changes in existing accounting rules or the interpretations of those rules;

our ability to raise additional capital or obtain additional financing;

our ability and the ability of our subsidiaries to borrow under current financing arrangements and maintain compliance with debt covenants;

relationship with and our guarantees of certain of the liabilities and indebtedness of our subsidiaries;

whether outstanding warrants issued in a prior private placement will be exercised in the future;

our ability to successfully achieve the anticipated benefits of the merger:

eCOST s potential indemnification obligations to its former parent;

eCOST s ability to maintain existing and build new relationships with manufacturers and vendors and the success of its advertising and marketing efforts;

eCOST s ability to increase its sales revenue and sales margin and improve operating efficiencies; and

eCOST s ability to generate a profit and cash flows sufficient to cover the values of its intangible assets.

We have based these statements on our current expectations about future events. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future.

Overview

We are an international provider of integrated business process outsourcing solutions to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional business and e-commerce initiatives as well as a leading multi-category online discount retailer of new, close-out and recertified brand-name merchandise. We derive our revenues from three business segments: business process outsourcing, a master distributor and a discount online retailer.

First, in our business process outsourcing business we derive our revenues from a broad range of services, including professional consulting, technology collaboration, order management, managed web hosting and web development, customer relationship management, financial services including billing and collection services and working capital solutions, kitting and assembly services, information management and international fulfillment and distribution services. We offer our services as an integrated solution, which enables our clients to outsource their complete infrastructure needs to a single source and to focus on their core competencies. Our distribution services are conducted at warehouses that we lease or manage and include real-time inventory management and customized picking, packing and shipping of our clients customer orders. We currently offer the ability to provide infrastructure and distribution solutions to clients that operate in a range of vertical markets, including technology manufacturing, computer products, printers, cosmetics, fragile goods, high security collectibles, pharmaceuticals, contemporary home furnishings, apparel, aviation, telecommunications and consumer electronics, among others.

In this business process outsourcing segment, we do not own the underlying inventory or the resulting accounts receivable, but provide management services for these client-owned assets. We typically charge our service fee revenue on a cost-plus basis, a percent of shipped revenue basis or a per-transaction basis, such as a per-minute basis for web-enabled customer contact center services and a per-item basis for fulfillment services. Additional fees are billed for other services. We price our services based on a variety of factors, including the depth and complexity of the services provided, the amount of capital expenditures or systems customization required, the length of contract and other factors.

Many of our service fee contracts involve third-party vendors who provide additional services such as package delivery. The costs we are charged by these third-party vendors for these services are often passed on to our clients. Our billings for reimbursements of these and other out-of-pocket expenses include travel, shipping and handling costs and telecommunication charges are included in pass-through revenue.

Our second business segment is a product revenue model. In this segment, we are a master distributor of product for IBM and certain other clients. In this capacity, we purchase, and thus own, inventory and recognize the corresponding product revenue. As a result, upon the sale of inventory, we own the accounts receivable. Freight costs billed to customers are reflected as components of product revenue. This business segment requires significant working capital requirements, for which we have senior credit facilities to provide for more than $80 million of available financing.

Our third business segment is a web-commerce product revenue model focused on the sale of products to a broad range of consumer and small business customers. In this segment we operate as a multi-category online discount retailer of new, close-out and recertified brand-name merchandise. Our product line currently offers approximately 100,000 products in several primary merchandise categories, primarily including computer hardware and software, home electronics, digital imaging, watches and jewelry, housewares, DVD movies, video games and cellular/wireless.

Growth is a key element to achieving our future goals, including achieving and maintaining sustainable profitability. Growth in our business process outsourcing segment is driven by two main elements: new client relationships and organic growth from existing clients. We focus our sales efforts on larger contracts with brand-name companies within two primary target markets, which, by nature, require a longer duration to close but also often provide the opportunity to be higher-quality and longer duration engagements. Our

results for the six months ended June 30, 2007 include approximately $4.5 million of new revenue including certain incremental projects.

Growth within our product revenue business is primarily driven by our ability to attract new master distributor arrangements with IBM or other manufacturers and the sales and marketing efforts of the manufacturers and third party sales partners.

Growth within our web-commerce product revenue model is primarily driven by eCOST s ability to increase sales and expand its product line.

We continue to monitor and control our costs to focus on profitability. While we are targeting our new service fee contracts to yield increased gross profit, we also expect to incur incremental investments to implement new contracts, investments in infrastructure and sales and marketing to support our targeted growth and increased public company professional fees.

Our expenses comprise primarily four categories: 1) cost of product revenue, 2) cost of service fee revenue, 3) cost of pass-through revenue and 4) operating expenses.

Cost of product revenues consists of the purchase price of product sold and freight costs, which are reduced by certain reimbursable expenses. These reimbursable expenses include pass-through customer marketing programs, direct costs incurred in passing on any price decreases offered by vendors to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and certain other expenses as defined under the master distributor agreements. Vendor marketing programs, such as co-op advertising, also reduce cost of product revenue.

Cost of service fee revenue consists primarily of compensation and related expenses for our web-enabled customer contact center services, international fulfillment and distribution services and professional consulting services, and other fixed and variable expenses directly related to providing services under the terms of fee based contracts, including certain occupancy and information technology costs and depreciation and amortization expenses.

Cost of pass-through revenue the related reimbursable costs for pass-through expenditures are reflected as cost of pass-through revenue.

Operating expenses consist primarily of selling, general and administrative (SG&A) expenses such as compensation and related expenses for sales and marketing staff, advertising, on-line marketing and catalog production, distribution costs (excluding freight) applicable to the Supplies Distributors and eCOST businesses, executive, management and administrative personnel and other overhead costs, including certain occupancy and information technology costs and depreciation and amortization expenses.

Monitoring and controlling our available cash balances continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. In recent years we have added to our available cash and liquidity positions through various transactions:

Each of our primary operating subsidiaries has one or more asset based working capital financing agreements with various lenders.

The private placement of approximately 6.6 million shares of our common stock to certain investors that provided net proceeds of approximately $8.0 million. Certain of these investors exercised warrants issued in conjunction with one of these private placements which provided an additional $1.3 million of proceeds upon the issuance of 0.4 million shares of common stock.

We received proceeds of $5.0 million of taxable revenue bonds to finance capital additions to our new facility in Southaven, MS.

Results of Operations

The following table sets forth certain historical financial information from our unaudited interim condensed consolidated statements of operations expressed as a percent of net revenues.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007 (Unaudited)	2006 (Unaudited)	2007 (Unaudited)	2006 (Unaudited)
Product revenue, net	78.1%	82.0%	77.6%	81.8%
Service fee revenue	16.3	14.8	16.3	14.6
Pass-through revenue	5.6	3.2	6.1	3.6
Total revenues	100.0	100.0	100.0	100.0
Cost of product revenue (as % of product revenue)	91.9	94.2	92.4	93.9
Cost of service fee revenue (as % of net service fee revenue)	71.6	70.1	73.1	70.8
Cost of pass-through revenue (as % of pass-through revenue)	100.0	100.0	100.0	100.0
Total costs of revenues	89.0	90.8	89.7	90.7
Gross profit	11.0	9.2	10.3	9.3
Operating expenses	10.0	11.5	10.5	10.9
Income (loss) from operations	1.0	(2.3)	(0.2)	(1.6)
Interest expense, net	0.6	0.5	0.6	0.4
Income (loss) before income taxes	0.4	(2.8)	(0.8)	(2.0)
Income tax expense	0.3	0.1	0.2	0.2
Net income (loss)	0.1%	(2.9)%	(1.0)%	(2.2)%

Results of Operations for the Interim Periods Ended June 30, 2007 and 2006

Product Revenue. Product revenue was $84.7 million for the three months ended June 30, 2007, as compared to $89.7 million for the three months ended June 30, 2006, a decrease of $5.0 million, or 5.5%. eCOST s product revenue decreased $1.7 million compared to the same period in the prior year due to improved pricing controls which have reduced low margin sales transactions and improved gross margins. Supplies Distributors product revenue decreased $3.3 million, or 5.4%, primarily due to the decreased sales volume of certain product due to enhancements of certain products useful lives and the impact of foreign currency fluctuations which created alternative purchasing channels for certain customers.

Product revenue for the six months ended June 30, 2007 was $165.1 million as compared to $179.9 million, a decrease of $14.8 million, or 8.2%, in the same period of the prior year. Excluding the $50.8 million of product revenue of eCOST following its acquisition in February 2006, product revenue decreased $12.9 million, or 10.0%, primarily due to decreased sales volume of certain product and the incremental vendor promotion activity in the March 2006 period, which did not occur in 2007.

Service Fee Revenue. Service fee revenue was $17.6 million for the three months ended June 30, 2007 as compared to $16.2 million for the three months ended June 30, 2006, an increase of $1.4 million or 8.9%. Service fees for the six months ended June 30, 2007 and 2006 were $34.6 million and $32.1 million, respectively, an increase of $2.5 million or 7.7%. Service fee revenue for the three and six months ended June 30, 2007 and 2006 include service fees generated from incremental projects with certain client relationships. The change in service fee revenue is shown below ($ millions):

	Three Months	Six Months
Period ended June 30, 2006	$ 16.2	$ 32.1
New service contract relationships, including certain incremental projects under new contracts	2.6	4.5
Change in existing client service fees and certain incremental projects with existing clients	(0.4)	(0.1)
Terminated clients not included in 2007 revenue	(0.8)	(1.9)
Period ended June 30, 2007	$ 17.6	$ 34.6

Cost of Product Revenue. Cost of product revenue was $77.8 million for the three months ended June 30, 2007, as compared to $84.5 million for the three months ended June 30, 2006, a decrease of $6.7 million or 7.9%. eCOST s cost of product revenue decreased $2.8 million or 10.2% to $24.9 million in the 2007 period compared to $27.7 million in the comparable 2006 period. As a percentage of product revenue eCOST s cost of product revenue decreased to 91.9% during the three month period ended June 30, 2007 from 96.3% in the period ended June 30, 2006. The resulting gross margin for eCOST was 8.1% in the 2007 period and 3.7% during the 2006 period. Gross margin for eCOST for the period ended June 30, 2006 included elevated levels of fraudulent credit card chargeback activity that resulted in approximately $0.7 million higher than normal chargebacks. eCOST also recorded an incremental provision of excess and obsolete inventory of $0.3 million in the June 2006 quarter due to an increase in slower moving product on hand. In addition, gross margin for eCOST increased from the prior year due to improved product pricing controls and freight initiatives.

Cost of product revenue for Supplies Distributors decreased $3.9 million or 6.8% primarily as the result of decreased sales volumes of certain products. Cost of product revenue, as a percent of product revenue, for Supplies Distributors, was 91.9% during the three months ended June 30, 2007 and 93.3% for the comparable 2006 period. The resulting gross profit margin was 8.1% for the three months ended June 30, 2007 and 6.7% for the same period in 2006. The gross profit margin for the 2007 period includes the impact of certain incremental inventory cost reductions.

Cost of product revenue was $152.6 million for the six months ended June 30, 2007, as compared to $168.8 million for the six months ended June 30, 2006, a decrease of $16.2 million or 9.6%. Cost of product revenue for the six months ended June 30, 2007 includes six months of activity for eCOST as compared to five months in the six month period ended June 30, 2006 following the acquisition of eCOST in February 2006. eCOST s cost of product revenue decreased to 91.8% during the six month period ended June 30, 2007 from 95.2 % in the June 30, 2006 period. The resulting gross margin for eCOST was 8.2% in the 2007 period and 4.8% during the 2006 period. Gross margin for eCOST for the period ended June 30, 2006 included elevated fraudulent credit card activity, an increased provision for excess and obsolete inventory and the impact of $0.4 million loss applicable to a sales transaction with a former eCOST customer. In addition, gross margin for eCOST increased from the prior year due to improved product pricing controls and freight pricing initiatives.

Supplies Distributors cost of product revenue decreased $12.8 million or 10.7% in the 2007 six month period. Cost of product revenue, as a percent of product revenue, was 92.7% during the six months ended June 30, 2007 and 93.4% during the six months ended June 30, 2006. The resulting gross profit margin was 7.3% for the six months ended June 30, 2007 and 6.6% for the six months ended June 30, 2006. Gross profit margin for the 2007 period includes the impact of certain incremental inventory cost reductions.

Cost of Service Fee Revenue. Cost of service fee revenue was $12.6 million for the three months ended June 30, 2007, as compared to $11.4 million during the three months ended June 30, 2006, an increase of $1.2 million or 11.2%. The resulting service fee gross profit was $5.0 million or 28.4% of service fee revenue, during the three months ended June 30, 2007 as compared to $4.8 million, or 29.9% of service fee revenue for the three months ended June 30, 2006. The decrease in gross profit as a percent of service fees for the three months ended June 30, 2007 is primarily due to lower margins on new client implementation activity and less higher margin project activity.

Cost of service fee revenue was $25.3 million for the six months ended June 30, 2007, as compared to $22.7 million during the six months ended June 30, 2006, an increase of $2.6 million or 11.2%. The resulting service fee gross profit was $9.3 million or 26.9% of service fee revenue, during the six months ended June 30, 2007 as compared to $9.4 million, or 29.2% of service fee revenue for the six months ended June 30, 2006. The decrease in gross profit as a percentage of service fees in the 2007 period is primarily due to a reduced level of higher margin client project activity compared to the 2006 period and lower margins on new client implementations. As we add new service fee revenue in the future, we currently intend to target the underlying contracts to earn an average gross profit percentage of 25-30%, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors.

Operating Expenses. Operating expenses were $10.8 million for the three months ended June 30, 2007, or 10.0% of total net revenues, as compared to $12.5 million, or 11.5% of total net revenues, for the three

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months ended June 30, 2006. The decrease in operating expenses is primarily due to continued recognition of expected benefits from cost savings initiatives at eCOST and a reduction in eCOST advertising expenses.

Operating expenses were $22.4 million for the six months ended June 30, 2007, or 10.5% of total net revenues, as compared to $23.9 million, or 10.9% of total net revenues, for the six months ended June 30, 2006. Operating expenses for the six months ended June 30, 2007 include six months of activity for eCOST as compared to only five months of activity in the six month period ended June 30, 2006 following the acquisition of eCOST in February 2006. eCOST s operating expenses declined during 2007 by $2.4 million as compared to the prior year primarily due to the realization of savings through the reduction of certain advertising and overhead expenses, changes in corporate infrastructure expenses and operating efficiencies attained as a result of the eCOST integration.

Excluding eCOST, operating expenses were $16.2 million, or 9.9% of total net revenues in the six months ended June 30, 2007 and $15.0 million, or 8.8% of total net revenues in the comparable prior year period. The increase in operating expenses is primarily due to additional facility and personnel related expenses.

Income Taxes. For the three months ended June 30, 2007 and 2006, we recorded a tax provision of $0.3 million and $0.1 million, respectively, associated primarily with our subsidiary Supplies Distributors Canadian and European operations. For the six month periods ended June 30, 2007 and 2006, we recorded a tax provision of $0.5 million and $0.4 million, respectively, for those same operations. We did not record a federal income tax benefit associated with our consolidated net loss in our U.S. operations or for our PFSweb Canadian pre-tax losses in the current or prior periods. A valuation allowance has been provided for the majority of our net deferred tax assets as of June 30, 2007 and December 31, 2006, which are primarily related to our net operating loss carryforwards, and certain foreign deferred tax assets. We expect that we will continue to record an income tax provision associated with Supplies Distributors Canadian and European results of operations.

Liquidity and Capital Resources

Net cash provided by operating activities was $0.4 million for the six months ended June 30, 2007, and primarily resulted from $2.8 million of net income, after adjusting consolidated net loss for non-cash items, a $1.1 million decrease in accounts receivable and a $3.1 million decrease in inventory, partially offset by a decrease in accounts payable, accrued expenses and other liabilities of $6.2 million and an increase in restricted cash of $0.6 million.

Net cash provided by operating activities was $1.0 million for the six months ended June 30, 2006, and primarily resulted from a $3.0 million increase in accounts payable, accrued expenses and other liabilities, a decrease in accounts receivable of $2.2 million, a $1.0 million decrease in prepaid expenses, other receivables and other current assets and a $0.9 million decrease in restricted cash partially offset by an increase in inventories of $6.2 million.

Net cash used in investing activities for the six months ended June 30, 2007 totaled $1.8 million, representing capital expenditures of $2.0 million offset by a decrease in restricted cash of $0.2 million.

Net cash used in investing activities for the six months ended June 30, 2006 totaled $2.7 million, representing capital expenditures of $2.1 million and cash paid to acquire eCOST, net of cash acquired, of $1.3 million, offset by a decrease in restricted cash of $0.7 million.

Capital expenditures have historically consisted primarily of additions to upgrade our management information systems, and general expansion of our facilities, both domestic and foreign. We expect to incur capital expenditures to support new contracts and anticipated future growth opportunities. Based on our current client business activity and our targeted growth plans, we anticipate that our total investment in upgrades and additions to facilities and information technology services for the upcoming twelve months

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will be approximately $5 to $7 million, although additional capital expenditures may be necessary to support the infrastructure requirements of new clients as well as the eCOST infrastructure. To maintain our current operating cash position, a portion of these expenditures may be financed through debt, operating or capital leases or additional equity. We may elect to modify or defer a portion of such anticipated investments in the event that we do not obtain the financing or achieve the revenue necessary to support such investments.

Net cash provided by financing activities was approximately $1.8 million for the six months ended June 30, 2007, primarily representing a $1.3 million decrease in restricted cash and $1.5 million of proceeds from debt, partially offset by $1.0 million of payments on capital leases.

Net cash provided by financing activities was approximately $5.7 million for the six months ended June 30, 2006, primarily representing $4.9 million of net proceeds from issuance of common stock pursuant to a private placement transaction and $1.2 million of proceeds on debt, offset by $0.7 million of payments on capital leases and $0.2 million decrease in restricted cash.

Our liquidity has been negatively impacted as a result of the merger with eCOST. During the six months ended June 30, 2007 and the year ended December 31, 2006, eCOST experienced a net usage of cash primarily due to losses incurred. As a result, during the process of transitioning and integrating eCOST s operations, PFSweb has had to support eCOST s cash needs with the goal of achieving a stabilized operational position. The amount of further cash needed to support eCOST operations will depend upon the financing available as well as eCOST s continued ability to improve its financial results.

We initially targeted that eCOST, as part of a combined Company, would achieve annual recurring cost savings of approximately $4 million to $5 million, dependent upon sales volumes, as compared to pre-merger levels. These targeted savings were expected to result from, among other things, the reduction of certain overhead expenses, changes in corporate infrastructure and reduced freight costs. As we have now completed the integration of eCOST into our infrastructure, we have begun to realize the expected benefits of many of these cost savings initiatives, though due to reduced sales volumes, the actual realized freight cost savings are less than originally anticipated. We currently expect eCOST s results to improve during 2007 and beyond as a result of planned efforts to increase sales, improve product mix and further improve operational efficiencies.

During the six months ended June 30, 2007, our working capital decreased to $17.0 million from $21.2 million at December 31, 2006, primarily as a result of the reclassification of $3.2 million in taxable revenue bonds to short-term debt due to the April 2008 maturity of the related letters of credit securing the taxable revenue bonds and the use of cash to support operating losses. To obtain additional financing in the future, in addition to our current cash position, we plan to evaluate various financing alternatives including the sale of equity, utilizing capital or operating leases, borrowing under our credit facilities, expanding our current credit facilities, entering into new debt agreements or transferring to third parties a portion of our subordinated loan balance due from Supplies Distributors. In conjunction with certain of these alternatives, we may be required to provide certain letters of credit to secure these arrangements. No assurances can be given that we will be successful in obtaining any additional financing or the terms thereof. We currently believe that our cash position, financing available under our credit facilities and funds generated from operations (including our anticipated revenue growth and/or cost reductions to offset lower than anticipated revenue growth) will satisfy our presently known operating cash needs, our working capital and capital expenditure requirements, our lease obligations, and additional loans to our subsidiaries Supplies Distributors and eCOST, if necessary, for at least the next twelve months.

The following is a schedule of our total contractual cash obligations which is comprised of operating leases, debt, vendor financing and capital leases (including interest) as of June 30, 2007, (in millions):

		Payments Due By Period			
Contractual Obligations	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Debt and vendor financing	$ 64,455	$ 60,354	$ 2,265	$ 1,836	$
Capital lease obligations	4,604	2,203	1,983	418	

Operating leases	22,398	7,491	10,265	4,562	80
Total	$ 91,457	$ 70,048	$ 14,513	$ 6,816	$ 80

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As of June 30 2007, we had $1.8 million of cash restricted for payment of capital expenditures or repayments to lenders. In addition, as described above, we have provided collateralized guarantees to secure the repayment of certain of our subsidiaries credit facilities. Many of these facilities include both financial and non-financial covenants, and also include cross default provisions applicable to other credit facilities and agreements. These covenants include minimum levels of net worth for the individual borrower subsidiaries and restrictions on the ability of the borrower subsidiaries to advance funds to other borrower subsidiaries. To the extent we fail to comply with our debt covenants, including the monthly financial covenant requirements and our required level of shareholders equity, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. In particular, in the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and payment under our parent guaranty. A requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of June 30, 2007, we were in compliance with all debt covenants. We do not have any other material financial commitments, although future client contracts may require capital expenditures and lease commitments to support the services provided to such clients.

In the future, we may attempt to acquire other businesses or seek an equity or strategic partner to generate capital or expand our services or capabilities in connection with our efforts to grow our business. Acquisitions involve certain risks and uncertainties and may require additional financing. Therefore, we can give no assurance with respect to whether we will be successful in identifying businesses to acquire or an equity or strategic partner, whether we or they will be able to obtain financing to complete a transaction, or whether we or they will be successful in operating the acquired business.

To finance their distribution of IBM products, Supplies Distributors and its subsidiaries have short-term credit facilities with IBM Credit LLC (IBM Credit) and IBM Belgium Financial Services S.A. (IBM Belgium). We have provided a collateralized guaranty to secure the repayment of these credit facilities. These asset-based credit facilities provided financing for up to $30.5 million and up to 12.5 million Euros (approximately $16.9 million) with IBM Credit and IBM Belgium, respectively. These agreements expire in March 2008.

Supplies Distributors also has a loan and security agreement with Wachovia Bank, N.A. (Wachovia) to provide financing for up to $25 million of eligible accounts receivables in the United States and Canada. The Wachovia facility expires on the earlier of March 29, 2009 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement.

Supplies Distributors European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (Fortis) to provide factoring for up to 7.5 million Euros (approximately $10.1 million) of eligible accounts receivables through March 2008.

These credit facilities contain cross default provisions, various restrictions upon the ability of Supplies Distributors and its subsidiaries to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as cash flow from operations, annualized revenue to working capital, net profit after tax to revenue, minimum net worth and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, we are required to maintain a subordinated loan to Supplies Distributors of no less than $6.0 million, maintain restricted cash of less than $5.0 million, are restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure and a minimum shareholders equity of at least $18.0 million. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors or its subsidiaries under these facilities if they are unable to do so. We have also provided a guarantee of the obligations of Supplies Distributors

and its subsidiaries to IBM, excluding the trade payables that are financed by IBM credit.

Our subsidiary, Priority Fulfillment Services, Inc. (PFS), has entered into a Loan and Security Agreement with Comerica Bank (Comerica), which provides for up to $10.0 million of eligible accounts receivable financing through March 2008, provided a $1.5 million Term Loan due in equal monthly installments through December 2007 and provided for up to $2.5 million of eligible equipment purchases through June 2008. We entered this Agreement to supplement our existing cash position, and provide funding for our current and future operations, including our targeted growth. The Agreement contains cross default provisions, various restrictions upon our ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to subsidiaries, affiliates and related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, and a minimum liquidity ratio, as defined. The agreement also limits PFS s ability to increase the subordinated loan to Supplies Distributors to more than $8.0 million or advance more than $8.5 million to eCOST without Comerica s approval. The agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb.

eCOST currently has an asset-based line of credit facility of up to $7.5 million with Wachovia Capital Finance Corporation (Western), which is collateralized by substantially all of eCOST s assets and expires in May 2009. Borrowings under the facility are limited to a percentage of eligible accounts receivable and letter of credit availability is limited to a percentage of accounts receivable and inventory. As of June 30, 2007, eCOST had $1.8 million of letters of credit outstanding and $1.2 million of available under this facility. Outstanding amounts under the facility bear interest at rates ranging from the prime rate to the prime rate plus 0.5% (8.75% as of June 30, 2007), depending on eCOST s financial results. The credit facility restricts eCOST s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as a minimum tangible net worth of $0 million, as defined. PFSweb has guaranteed all current and future obligations of eCOST under this line of credit.

In 2003, we entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which we issued and sold an aggregate of 1.6 million shares of our common stock (the Common Stock), In addition to the Common Stock, the investors received certain warrants to purchase shares of Common Stock at a specified exercise price. The adjusted exercise price of the outstanding warrants is $2.31 per share and the adjusted number of warrants is 564,980. In addition, in connection with the merger with eCOST, we assumed outstanding warrants to issue an aggregate of 36,210 shares of common stock at an exercise price of $2.00 per share, subject to the terms set forth therein.

In 2004, to fulfill our obligations under certain new client relationships, we entered into a three-year operating lease arrangement for a new distribution facility in Southaven, MS, near our existing distribution complex in Memphis, TN. We incurred more than $5 million in capital expenditures to support the incremental business in this new distribution center. We financed a significant portion of these expenditures through a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) pursuant to which the MBFC issued $5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned us the proceeds of the Bonds for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in our new Southaven, Mississippi distribution facility. The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) in the initial face amount of $5.1 million issued by Comerica pursuant to a Reimbursement Agreement between us and Comerica under which we are obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of April 2008 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. The current amount outstanding on this Loan Agreement as of June 30, 2007 is $4.0 million.

In June 2006, we entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which we issued and sold an aggregate of 5.0 million shares of our common stock, par value $.001 per share, at $1.00 per share, resulting in gross proceeds of $5.0 million. After deducting expenses, the net proceeds were approximately $4.8 million. We have advanced the net proceeds to eCOST to support its operating requirements.

To the extent we fail to comply with the various debt covenants described above, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. Any requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of June 30, 2007, we were in compliance with all debt covenants.

Through our merger with eCOST, we have aligned the core strengths of each company to leverage our operational infrastructure and technology expertise with eCOST s customer base and supplier relationships. We initially targeted to achieve $4 million to $5 million in annual cost savings, dependent upon sales volumes, as compared to pre-merger levels. These targeted savings were expected to result from, among other things, reductions in the following costs:

- Certain redundant administrative and public company activities;
- Excess capacity and other related facility expenses;
- Technology, telecommunications and operational costs; and
- Overall outbound freight costs due to additional freight options.

As we have completed the integration of eCOST into our infrastructure, we are realizing the expected benefits of many of these cost saving initiatives, though due to reduced sales volumes, the freight cost savings that have occurred are less than originally anticipated.

Additionally, we believe the combined companies can pursue a variety of incremental revenue and gross profit-related opportunities, such as:

- Increase the number of virtual warehouse partnerships for both electronics and non-electronic goods;
- Develop higher margin non-product and service categories;
- Expand international sales, particularly in Europe and Canada, where we maintain a presence; and
- Utilize our stronger financial platform to enhance eCOST s working capital resources to expand access to exclusive products and deals.

We can provide no assurance that such plans or the underlying financial benefits will be achieved. Additionally, even with such plans, we expect that eCOST will operate at a loss during 2007 and will require further funding to support its operations.

eCOST has historically incurred significant operating losses and used cash to fund its operations. As a result, we have been required to invest cash to fund eCOST s operations, which we may not be able to continue to do without approval from our lenders. The amount of further cash needed to support eCOST operations depends upon the financing available under its credit line as well as eCOST s ability to improve its financial results. Through August 13, 2007, we have advanced $11.6 million to eCOST to fund eCOST s cash flow requirements and have lender approval to advance an additional $1.6 million, with certain restrictions, if needed. In the event we need to invest further cash to eCOST, we may be required to seek approval from our lenders to provide such funds. We can provide no assurance that we will receive such approval from our lenders or any terms or conditions required by our lenders in order to obtain such approval. In addition, PFSweb has provided a guaranty of eCOST s bank line of credit and certain eCOST vendor trade payables.

If eCOST is unable to meet its requirements under its debt obligations and bank facility, the guarantees referred to above could be called upon.

We receive municipal tax abatements in certain locations. During 2004 we received notice from a municipality that we did not satisfy certain criteria necessary to maintain the abatements. In December 2006, we received notice that the municipal authority planned to make an adjustment to our tax abatement. We plan to dispute the adjustment, but if the dispute is not resolved favorably, additional taxes of $1.5 million could be assessed against us through June 30, 2007.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek s Plan of Liquidation. The complaint alleged, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. On May 3, 2007, the Court granted certain motions for summary judgment filed by the Company and certain of the former Daisytek directors. As a result of this ruling, all of the claims against the Company have been dismissed although certain of the claims against certain of the individual defendants remain. Through June 30, 2007, we have incurred outstanding legal costs of approximately $1.2 million, which have not been paid as we expect such costs to be covered by insurance.

On July 12, 2004, eCOST received correspondence from MercExchange LLC alleging infringement of MercExchange s U.S. patents relating to e-commerce and offering to license its patent portfolio to eCOST. On July 15, 2004, eCOST received a follow-up letter from MercExchange specifying which of its technologies MercExchange believed infringed certain of its patents, alone or in combination with technologies provided by third parties. Some of those patents are currently being litigated by third parties, and we are not involved in those proceedings. In addition, three of the four patents identified by MercExchange are under reexamination at the U.S. Patent and Trademark Office, which may or may not result in the modification of those claims. In the July 15 letter, MercExchange also advised eCOST that it has a number of applications pending for additional patents. MercExchange has filed lawsuits alleging infringement of some or all of its patents against third parties, resulting in settlements or verdicts in favor of MercExchange. At least one such verdict was appealed to the United States Court of Appeals for the Federal Circuit and was affirmed in part. Recently, the Supreme Court reversed the ruling by the United States Court of Appeals for the Federal Circuit Court requiring that an injunction must be issued in that case. Based on eCOST s investigation of this matter to date, we believe that our current eCOST operations do not infringe any valid claims of the patents identified by MercExchange in these letters. There can be no assurance, however, that such claims will not be material or adversely affect our business, financial position, results of operations or cash flows.

On July 25, 2007 a purported class action lawsuit entitled *Darral Frank and Joseph F. Keeley, Jr.. v. PC Mall, Inc. dba eCOST.com and eCOST.com, Inc.* was filed in the Superior Court of California, Los Angeles County. The purported class consists of all of current and former sales representatives who worked for the defendants in California from July 24, 2003 through July 24, 2007. The lawsuit alleges that the defendants failed to pay overtime compensation and interest thereon, failed to timely pay compensation to terminated employees and failed to provide meal and rest periods, all in violation of the California Labor Code and Business and Professions Code. The complaint seeks unpaid overtime, statutory penalties, interest, attorneys fees, punitive damages, restitution and injunctive relief. We intend to vigorously contest this action and do not believe the claims have any merit.

Seasonality

The seasonality of our service fee business is dependent upon the seasonality of our clients business and sales of their products. Accordingly, our management must rely upon the projections of our clients in assessing quarterly variability. We believe that with our current client mix and their current business volumes, our service fee business activity will be at it lowest in the quarter ended March 31. We anticipate that our Supplies Distributors product revenue will be highest during the quarter ended December 31. Our eCOST business is moderately seasonal, reflecting the general pattern of peak sales for the retail industry during the holiday shopping season. Typically, a larger portion of our eCOST revenues occur during the first and fourth fiscal quarters. We believe that our historical revenue growth makes it difficult to predict the effect of seasonality on our future revenues and results of operations.

We believe that results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year.

Inflation

Management believes that inflation has not had a material effect on our operations.

Critical Accounting Policies

A description of critical accounting policies is included in Note 2 of the consolidated financial statements in our December 31, 2006 Annual Report on Form 10-K.

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ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

We are exposed to various market risks including interest rates on its financial instruments and foreign exchange rates.

Interest Rate Risk

Our interest rate risk is limited to our outstanding balances on our inventory and working capital financing agreements, taxable revenue bonds, loan and security agreements and factoring agreement for the financing of inventory, accounts receivable and certain other receivables and certain equipment, which amounted to $63.3 million at June 30, 2007. A 100 basis point movement in interest rates would result in approximately $0.4 million annualized increase or decrease in interest expense based on the outstanding balance of these agreements at June 30, 2007.

Foreign Exchange Risk

Currently, our foreign currency exchange rate risk is primarily limited to the Canadian Dollar and the Euro. In the future, our foreign currency exchange risk may also include other currencies applicable to certain of our international operations. We have and may continue, from time to time, to employ derivative financial instruments to manage our exposure to fluctuations in foreign currency rates. To hedge our net investment and intercompany payable or receivable balances in foreign operations, we may enter into forward currency exchange contracts.

ITEM 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of management, including our Chief Executive Officer and Principal Financial and Accounting Officer. Based upon the evaluation, our Chief Executive Officer and Principal Financial and Accounting Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic Securities and Exchange Commission filings. No significant changes were made to our internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation.

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PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek s Plan of Liquidation. The complaint alleged, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. On May 3, 2007, the Court granted certain motions for summary judgment filed by the Company and certain of the former Daisytek directors. As a result of this ruling, all of the claims against the Company have been dismissed, although certain of the claims against certain of the individual defendants remain.

On July 25, 2007 a purported class action lawsuit entitled *Darral Frank and Joseph F. Keeley, Jr.. v. PC Mall, Inc. dba eCOST.com and eCOST.com, Inc.* was filed in the Superior Court of California, Los Angeles County. The purported class consists of all of current and former sales representatives who worked for the defendants in California from July 24, 2003 through July 24, 2007. The lawsuit alleges that the defendants failed to pay overtime compensation and interest thereon, failed to timely pay compensation to terminated employees and failed to provide meal and rest periods, all in violation of the California Labor Code and Business and Professions Code. The complaint seeks unpaid overtime, statutory penalties, interest, attorneys fees, punitive damages, restitution and injunctive relief. We intend to vigorously contest this action and do not believe the claims have any merit.

ITEM 1A. Risk Factors

Our business, financial condition and operating results could be adversely affected by any of the following factors, in which event the trading price of our common stock could decline, and you could lose part or all of your investment.

Risks Related to All Our Business Segments

Certain of our historical financial information may not be representative of our future results.

Effective February 1, 2006, we now consolidate eCOST.com s financial position and results of our operations into our consolidated financial statements. As a result of our acquisition of eCOST, our historical results of operations may not be indicative of our future operating or financial performance.

We anticipate incurring significant expenses in the foreseeable future, which may reduce our ability to achieve or maintain profitability.

To reach our business growth objectives, we may increase our operating and marketing expenses, as well as capital expenditures. To offset these expenses, we will need to generate additional profitable business. If our revenue grows slower than either we anticipate or our clients projections indicate, or if our operating and marketing expenses exceed our expectations, we may not generate sufficient revenue to be profitable or be able to sustain or increase profitability on a quarterly or an annual basis in the future. Additionally, if our revenue grows slower than either we anticipate or our clients projections indicate, we may incur unnecessary or redundant costs and our operating results could be adversely affected.

Changes to financial accounting standards may affect our reported results of operations.

We prepare our financial statements to conform to generally accepted accounting principles, or GAAP. GAAP is subject to interpretation by the American Institute of Certified Public Accountants, the SEC and various bodies formed to interpret and create appropriate accounting policies. A change in those policies can have a significant effect on our reported results and may even affect our reporting of transactions that were completed before a change is announced. Accounting rules affecting many aspects of our business, including rules relating to accounting for asset impairments, revenue recognition, arrangements involving multiple deliverables, employee stock purchase plans and stock option grants, have recently been revised or are currently under review. Changes to those rules or current interpretation of those rules may have a material adverse effect on our reported financial results or on the way we conduct our business.

We operate with significant levels of indebtedness and are required to comply with certain financial and non-financial covenants; we are required to maintain a minimum level of subordinated loans to our subsidiary Supplies Distributors; and we have guaranteed certain indebtedness and obligations of our subsidiaries Supplies Distributors and eCOST.

As of June 30, 2007, our total credit facilities outstanding, including debt, capital lease obligations and our vendor accounts payable related to financing of IBM product inventory, was approximately $67.9 million. Certain of the credit facilities have maturity dates in calendar year 2008 or after, but are classified as current liabilities in our consolidated financial statements. We cannot provide assurance that our credit facilities will be renewed by the lending parties. Additionally, these credit facilities include both financial and non-financial covenants, many of which also include cross default provisions applicable to other agreements. These covenants also restrict our ability to transfer funds among our various subsidiaries, which may adversely affect the ability of our subsidiaries to operate their businesses or comply with their respective loan covenants. We cannot provide assurance that we will be able to maintain compliance with these covenants. Any non-renewal or any default under any of our credit facilities would have a material adverse impact upon our business and financial condition. In addition we have provided $6.0 million of subordinated indebtedness to Supplies Distributors, the minimum level required under certain credit facilities as of June 30, 2007. The maximum level of this subordinated indebtedness to Supplies Distributors that may be provided without approval from our lenders is $8.0 million. The restrictions on increasing this amount without lender approval may limit our ability to comply with certain loan covenants or further grow and develop Supplies Distributors business. We have guaranteed most of the indebtedness of Supplies Distributors. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors by its lenders to the extent Supplies Distributors is unable to do so. We have also guaranteed eCOST s $7.5 million credit line with Wachovia, as well as certain of its vendor trade payables. We currently expect that it may be necessary to provide additional guarantees of certain eCOST vendor trade payables in the future.

We are dependent on our key personnel, and we need to hire and retain skilled personnel to sustain our business.

Our performance is highly dependent on the continued services of our executive officers and other key personnel, the loss of any of whom could materially adversely affect our business. In addition, we need to attract and retain other highly-skilled, technical and managerial personnel for whom there is intense competition. We cannot assure you that we will be able to attract and retain the personnel necessary for the continuing growth of our business. Our inability to attract and retain qualified technical and managerial personnel would materially adversely affect our ability to maintain and grow our business.

We are subject to risks associated with our international operations.

We currently operate a 150,000 square foot distribution center in Liege, Belgium and a 22,000 square foot distribution center in Markham, Canada, near Eastern Toronto, both of which currently have excess capacity. We recently opened a 6,500 square foot facility in the Philippines to provide call center and customer service functions. We cannot assure you that we will be successful in expanding in these or any additional international markets. In addition to the uncertainty regarding our ability to generate revenue from foreign operations and expand our international presence, there are risks inherent in doing business internationally, including:

- changing regulatory requirements;
- legal uncertainty regarding foreign laws, tariffs and other trade barriers;
- political instability;
- potentially adverse tax consequences;
- foreign currency fluctuations; and
- cultural differences.

Any one or more of these factors could materially adversely affect our business in a number of ways, such as increased costs, operational difficulties and reductions in revenue.

We are uncertain about our need for and the availability of additional funds.

Our future capital needs are difficult to predict. We may require additional capital to take advantage of unanticipated opportunities, including strategic alliances and acquisitions and to fund capital expenditures, or to respond to changing business conditions and unanticipated competitive pressures. We may also require additional funds to finance operating losses, including continuing operating losses currently anticipated to be incurred by eCOST. Should these circumstances arise, our existing cash balance and credit facilities may be insufficient and we may need to raise additional funds either by borrowing money or issuing additional equity. We cannot assure you that such resources will be adequate or available for all of our future financing needs. Our inability to finance our growth, either internally or externally, may limit our growth potential and our ability to execute our business strategy. If we are successful in completing an additional equity financing, this could result in further dilution to our shareholders or reduce the market value of our common stock.

We may engage in future strategic alliances or acquisitions that could dilute our existing shareholders, cause us to incur significant expenses or harm our business.

We may review strategic alliance or acquisition opportunities that would complement our current business or enhance our technological capabilities. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. To finance any acquisitions, it may be necessary for us to raise additional funds through borrowing money or completing public or private financings. Additional funds may not be available on terms that are favorable to us and, in the case of equity financings, may result in dilution to our shareholders. We may not be able to operate any acquired businesses profitably or otherwise implement our growth strategy successfully. If we are unable to integrate any newly acquired entities or technologies effectively, our operating results could suffer. Future acquisitions could also result in incremental expenses and the incurrence of debt and contingent liabilities, any of which could harm our operating results.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud. As a result, current and potential shareholders could lose confidence in our financial reporting, which could harm our business, and the trading price of our common stock.

We have begun a process to document and evaluate our internal controls over financial reporting to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent auditors addressing these assessments. Based on the current requirements and our public float, we were not required to comply with Section 404 as of December 31, 2006. We are currently subject to the management assessment portion of Section 404 for the year ending December 31, 2007, but we are not subject to the requirement to obtain a report by our independent auditors opining on these assessments. Under current law, we will be subject to the independent auditor requirement for the year ending December 31, 2008. In this regard, our management has been dedicating internal resources, has engaged outside consultants and has begun to develop a detailed work plan to (i) assess and document the adequacy of internal controls over financial reporting, (ii) take steps to improve control processes, where appropriate, and (iii) validate through testing that controls are functioning as documented. If we fail to correct any issues in the design or operating effectiveness of internal controls over financial reporting or fail to prevent fraud, current and potential shareholders could lose confidence in our financial reporting, which could harm our business and the trading price of our common stock.

Delivery of our and our clients products could be delayed or disrupted by factors beyond our control, and we could lose customers and clients as a result.

We rely upon third party carriers for timely delivery of our and our clients product shipments. As a result, we are subject to carrier disruptions and increased costs due to factors that are beyond our control, including employee strikes, inclement weather and increased fuel costs. Any failure to deliver products to our and our clients customers in a timely and accurate manner may damage our reputation and brand and could cause us to lose customers and clients. We cannot be sure that our relationships with third party carriers will continue on terms favorable to us, if at all. If our relationship with any of these third party carriers is terminated or impaired or if any of these third parties is unable to deliver products, we would be

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required to use alternative carriers for the shipment of our and our clients products to customers. We may be unable to engage alternative carriers on a timely basis or on favorable terms, if at all. Potential adverse consequences include:

reduced visibility of order status and package tracking;

delays in order processing and product delivery;

increased cost of delivery, resulting in reduced margins; and

reduced shipment quality, which may result in damaged products and customer dissatisfaction.

A breach of our e-commerce security measures could reduce demand for its services. Credit card fraud and other fraud could adversely affect our business.

A requirement of the continued growth of e-commerce is the secure transmission of confidential information over public networks. A party who is able to circumvent our security measures could misappropriate proprietary information or interrupt our operations. Any compromise or elimination of our security could reduce demand for our services.

We may be required to expend significant capital and other resources to protect against security breaches or to address any problem they may cause. Because our activities involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage its reputation, cause us to lose clients, impact our ability to attract new clients and we could be exposed to litigation and possible liability. Our security measures may not prevent security breaches, and failure to prevent security breaches may disrupt our operations. In certain circumstances, we do not carry insurance against the risk of credit card fraud and other fraud, so the failure to adequately control fraudulent transactions on our client s behalf could increase our expenses.

We are subject to a dispute with a municipal authority, which, if not resolved in our favor, may materially adversely affect our results of operations.

We receive municipal tax abatements in certain locations. During 2004 we received notice from a municipal authority that we did not satisfy certain criteria necessary to maintain the abatements. In December 2006 we received notice that the municipal authority planned to make an adjustment to our tax abatement. We plan to dispute the adjustment, but if the dispute is not resolved favorably, we could be subject to additional taxes of approximately $1.5 million..

Risks Related to Our PFS and Supplies Distributors Operating Segments

Our service fee revenue and gross margin is dependent upon our clients business and transaction volumes and our costs; many of our client service agreements are terminable by the client at will; we may incur financial penalties if we fail to meet contractual service levels under certain client service agreements.

Our service fee revenue is primarily transaction based and fluctuates with the volume of transactions or level of sales of the products by our clients for whom we provide transaction management services. If we are unable to retain existing clients or attract new clients or if we dedicate significant resources to clients whose business does not generate sufficient revenue or whose products do not generate substantial customer sales, our business may be materially adversely affected. Moreover, our ability to estimate service fee revenue for future periods is substantially dependent upon our clients and our own projections, the accuracy of which has been, and will continue to be, unpredictable. Therefore, our planning for client activity and targeted goals for service fee revenue and gross margin may be materially adversely affected by incomplete, delayed or inaccurate projections. In addition, many of our service agreements with our clients are terminable by the client at will. Therefore, we cannot assure you that any of our clients will continue to use our services for any period of time. The loss of a significant amount of service fee revenue due to client terminations could have a material adverse effect on our ability to cover our costs and thus on our profitability. Certain of our client service agreements contain minimum service level requirements and impose financial penalties if we fail to meet such requirements. The imposition of a substantial amount of such penalties could have a material adverse effect on our business and operations.

Our business is subject to the risk of customer and supplier concentration.

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For the six months ended June 30, 2007 and 2006, a prime contractor (for whom we are a subcontractor) to a U.S. government agency, a consumer products company and Xerox Corporation represented approximately 25%, 13% and 11%, respectively, and approximately 25%, 19% and 12%, respectively of our total service fee revenue, net of pass-through revenue. The loss of, or non-payment of invoices by, any or all of such clients would have a material adverse effect upon our business. In particular, the agreement under which we provide services to such clients are terminable at will upon notice by such clients.

A substantial portion of our Supplies Distributors product revenue was generated by sales of product purchased under master distributor agreements with the Printing System Division of IBM and is dependent on IBM s business and the continuing market for IBM products. In January 2007, IBM and Ricoh announced the planned formation of a joint venture company based on IBM s Printing Systems Division. Upon closing of the agreement in June 2007, Ricoh acquired 51% of the joint venture, which is called InfoPrint Solutions Company, and will progressively acquire the remaining 49% over the next three years. The newly formed joint venture company is expected to eventually become a fully owned subsidiary of Ricoh. No assurance can be given that InfoPrint Solutions Company will continue the master distributor agreements with Supplies Distributors. A termination of this relationship or a decline in customer demand for these products will have a material adverse effect on Supplies Distributors business and the Company s financial condition.

Sales by Supplies Distributors to three customers accounted for approximately 34% of Supplies Distributors total product revenue for the six months ended June 30, 2007. Sales to the same three customers accounted for approximately 39% of Supplies Distributors product revenues for the six months ended June 30, 2006. The loss of any one or more of such customers, or non-payment of any material amount by these or any other customer, would have a material adverse effect upon Supplies Distributors business.

Our operating results are materially impacted by our client mix and the seasonality of their business.

Our business is materially impacted by our client mix and the seasonality of their business. Based upon our current client mix and their current projected business volumes, we anticipate our service fee revenue business activity will be at its lowest in the first quarter of our fiscal year and that our master distributor product revenue business activity will be at its highest in the fourth quarter of our fiscal year. We believe results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year. We are unable to predict how the seasonality of future clients business may affect our quarterly revenue and whether the seasonality may change due to modifications to a client s business. As such, we believe that results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year.

Our systems may not accommodate significant growth in our number of clients.

Our success depends on our ability to handle a large number of transactions for many different clients in various product categories. We expect that the volume of transactions will increase significantly as we expand our operations. If this occurs, additional stress will be placed upon the network hardware and software that manages our operations. We cannot assure you of our ability to efficiently manage a large number of transactions. If we are not able to maintain an appropriate level of operating performance, we may develop a negative reputation, and impair existing and prospective client relationships and our business would be materially adversely affected.

We may not be able to recover all or a portion of our start-up costs associated with one or more of our clients.

We generally incur start-up costs in connection with the planning and implementation of business process solutions for our clients. Although we generally attempt to recover these costs from the client in the early stages of the client relationship, or upon contract termination if the client terminates without cause prior to full amortization of these costs, there is a risk that the client contract may not fully cover the start-up costs. To the extent start-up costs exceed the start-up fees received, excess costs will be expensed as incurred. Additionally, in connection with new client contracts we generally incur capital expenditures associated with assets whose primary use is related to the client solution. There is a risk that the contract may end before expected and we may not recover the full amount of our capital costs.

Our revenue and margins may be materially impacted by client transaction volumes that differ from client projections and business assumptions.

Our pricing for client transaction services, such as call center and fulfillment, is often based upon volume projections and business assumptions provided by the client and our anticipated costs to perform such work. In the event the actual level of activity or cost is substantially different from the projections or assumptions, we may have insufficient or excess staffing, incremental costs or other assets dedicated for such client that may negatively impact our margins and business relationship with such client. In the event we are unable to meet the service levels expected by the client, our relationship with the client will suffer and may result in financial penalties and/or the termination of the client contract.

We face competition from many sources that could adversely affect our business.

Many companies offer, on an individual basis, one or more of the same services we do, and we face competition from many different sources depending upon the type and range of services requested by a potential client. Our competitors include vertical outsourcers, which are companies that offer a single function, such as call centers, public warehouses or credit card processors. We compete against transportation logistics providers who offer product management functions as an ancillary service to their primary transportation services. We also compete against other business process outsourcing providers, who perform many similar services as us. Many of these companies have greater capabilities than we do for the single or multiple functions they provide. In many instances, our competition is the in-house operations of its potential clients themselves. The in-house operations of potential clients often believe that they can perform the same services we do, while others are reluctant to outsource business functions that involve direct customer contact. We cannot be certain that we will be able to compete successfully against these or other competitors in the future.

Our sales and implementation cycles are highly variable and our ability to finalize pending contracts may cause our operating results to vary widely.

The sales cycle for our services is variable, typically ranging between several months to up to a year from initial contact with the potential client to the signing of a contract. Occasionally the sales cycle requires substantially more time. Delays in signing and executing client contracts may affect our revenue and cause our operating results to vary widely. We believe that a potential client s decision to purchase our services is discretionary, involves a significant commitment of the client s resources and is influenced by intense internal and external pricing and operating comparisons. To successfully sell our services, we generally must educate our potential clients regarding the use and benefit of our services, which can require significant time and resources. Consequently, the period between initial contact and the purchase of our services is often long and subject to delays associated with the lengthy approval and competitive evaluation processes that typically accompany significant operational decisions. Additionally, the time required to finalize pending contracts and to implement our systems and integrate a new client can range from several weeks to many months. Delays in signing and integrating new clients may affect our revenue and cause our operating results to vary widely.

Our business could be adversely affected by a systems or equipment failure, whether that of us or our clients.

Our operations are dependent upon our ability to protect our distribution facilities, customer service centers, computer and telecommunications equipment and software systems against damage and failures. Damage or failures could result from fire, power loss, equipment malfunctions, system failures, natural disasters and other causes. If our business is interrupted either from accidents or the intentional acts of others, our business could be materially adversely affected. In addition, in the event of widespread damage or failures at our facilities, our short-term disaster recovery and contingency plans and insurance coverage may not be sufficient.

Our clients businesses may also be harmed from any system or equipment failures we experiences. In that event, our relationship with these clients may be adversely affected, we may lose these clients, our ability to attract new clients may be adversely affected and we could be exposed to liability.

Interruptions could also result from the intentional acts of others, like hackers. If our systems are penetrated by computer hackers, or if computer viruses infect our systems, our computers could fail or proprietary information could be misappropriated.

If our clients suffer similar interruptions in their operations, for any of the reasons discussed above or for others, our business could also be adversely affected. Many of our clients computer systems interface with our systems. If our clients suffer interruptions in their systems, the link to our systems could be severed and sales of the client s products could be slowed or stopped.

We may be a party to litigation involving our e-commerce intellectual property rights.

In recent years, there has been significant litigation in the United States involving patent and other intellectual property rights. We may be a party to intellectual property litigation in the future to protect our trade secrets or know-how. United States patent applications are confidential until a patent is issued and most technologies are developed in secret. Accordingly, we are not, and cannot be, aware of all patents or other intellectual property rights of which our services may pose a risk of infringement. Others asserting rights against us could force us to defend ourself or our customers against alleged infringement of intellectual property rights. We could incur substantial costs to prosecute or defend any such litigation.

Risks Related to the Business Process Outsourcing Industry

If the trend toward outsourcing does not continue, our business will be adversely affected.

Our business could be materially adversely affected if the trend toward outsourcing declines or reverses, or if corporations bring previously outsourced functions back in-house. Particularly during general economic downturns, businesses may bring in-house previously outsourced functions to avoid or delay layoffs. The continued threat of terrorism within the United States and abroad and the potential for sustained military action may cause disruption to commerce and economic conditions, both domestic and foreign, which could have a material adverse effect upon our business and new client prospects.

Our market is subject to rapid technological change and to compete we must continually enhance our systems to comply with evolving standards.

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our services and the underlying network infrastructure. If we are unable to adapt to changing market conditions, client requirements or emerging industry standards, our business could be adversely affected. The internet and e-commerce environments are characterized by rapid technological change, changes in user requirements and preferences, frequent new product and service introductions embodying new technologies and the emergence of new industry standards and practices that could render our technology and systems obsolete. Our success will depend, in part, on our ability to both internally develop and license leading technologies to enhance our existing services and develop new services. We must continue to address the increasingly sophisticated and varied needs of our clients and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. The development of proprietary technology involves significant technical and business risks. We may fail to develop new technologies effectively or to adapt our proprietary technology and systems to client requirements or emerging industry standards.

Risks Related to our Merger with eCOST

We may fail to realize the anticipated synergies, cost savings, growth opportunities and other benefits expected from the merger.

We entered into a merger with eCOST with the expectation that the merger will result in synergies, cost savings, growth opportunities and other benefits to the combined company. However, there can be no assurance that we will realize any of these anticipated benefits. The combination of our businesses may not result in combined financial performance that is better than what our company would have achieved independently if the merger had not occurred.

Uncertainty regarding the merger may cause clients, customers, suppliers and others to delay or defer decisions concerning us and eCOST, which may harm the results of operations of either or both companies.

In response to our completion of the merger, clients, customers and suppliers may delay or defer outsourcing, purchasing or supply decisions or otherwise alter existing relationships with us and eCOST. Prospective clients and customers could be reluctant to contract for the combined company s services or purchase the combined company s products due to uncertainty about the combined company s ability to efficiently provide products and services. In addition, clients, customers, suppliers and others may also seek to terminate or change existing agreements with us or eCOST as a result of the merger. These and other actions by clients, customers, suppliers and others could negatively affect the business of the combined company.

eCOST may be liable to PC Mall for taxes arising as a result of the merger.

In connection with the consummation of the merger, eCOST received a written opinion from its legal counsel to the effect that the merger should not cause Section 355(e) of the Internal Revenue Code to apply to the April 2005 spin-off of eCOST from its former parent, PC Mall. Such opinion was based on certain factual representations made by PC Mall and eCOST and certain factual and legal assumptions made by eCOST s legal counsel. Such opinion represented such legal counsel s best judgment regarding the application of the U.S. federal income tax laws, but is not binding on the IRS or the courts. No assurance can be given that the IRS will not assert a contrary position or that any such contrary position would not be sustained by a court. If the merger does cause Section 355(e) to apply to the April 2005 spin-off of eCOST from PC Mall, eCOST will be liable to PC Mall for any resulting tax-related liabilities.

Risks Related to eCOST, our Online Discount Retailer Segment

We may not be able to achieve or maintain profitability.

We have incurred continuing operating losses and may not be able to achieve or maintain profitability on a quarterly or annual basis. Our ability to achieve or maintain profitability depends on a number of factors, including our ability to:

- increase sales;
- maintain and expand vendor relationships;
- obtain additional and increase existing trade credit with key suppliers;
- generate sufficient gross profit; and
- control costs and generate the expected synergies applicable to the merger.

We need additional financing and may not be able to obtain additional financing on favorable terms or at all, which could increase our costs and limit our ability to grow.

We need to obtain additional financing and there can be no assurance that we will be able to obtain additional financing on commercially reasonable terms or at all. Our failure to obtain additional financing or our inability to obtain financing on acceptable terms will materially adversely affect our ability to achieve profitability and grow our business.

Our operating results are difficult to predict.

Our operating results have fluctuated in the past and are likely to vary significantly in the future based upon a number of factors, many of which we cannot control. We operate in a highly dynamic industry and future results could be subject to significant fluctuations. Revenue and expenses in future periods may be greater or less than revenue and expenses in the immediately preceding period or in the comparable period of the prior year. Therefore, period-to-period comparisons of our operating results are not necessarily a good indication of our future performance. Some of the factors that could cause our operating results to fluctuate include:

- price competition that results in lower sales volumes, lower profit margins, or net losses;
- our ability to prevent credit card fraud and reduce chargeback activity;

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the amount, timing and impact of advertising and marketing costs;

our ability to successfully implement new technologies or software systems;

our ability to obtain sufficient financing;

changes in the number of visitors to the out website or our inability to convert those visitors into customers;

technical difficulties, including system or Internet failures;

fluctuations in the demand for our products or overstocking or under-stocking of products;

fluctuations in revenues and shipping costs, particularly during the holiday season;

economic conditions generally or economic conditions specific to the Internet, online commerce, the retail industry or the mail order industry;

changes in the mix of products that we sell; and

fluctuations in levels of inventory theft, damage or obsolescence.

The failure to improve our financial and operating performance may result in a failure to comply with our financial covenants.

In the event we are unable to increase our revenue and/or gross profit from our present levels and do not achieve a sufficient level of operating efficiencies, we may fail to comply with one or more of the financial covenants required under our working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and payment under the parent guaranty.

If we fail to accurately predict our inventory risk, our margins may decline as a result of write-downs of our inventory due to lower prices obtained for older or obsolete products.

Some of the products we sell on our website are characterized by rapid technological change, obsolescence and price erosion (for example, computer hardware, software and consumer electronics), and because we may sometimes stock large quantities of particular types of inventory, inventory reserves may be required or may subsequently prove insufficient, and additional inventory write-downs may be required.

Increased product returns or a failure to accurately predict product returns could decrease our revenues and impact profitability.

We make allowances for product returns based on historical return rates. We are responsible for returns of certain products ordered through our website from our distribution center as well as products that are shipped to our customers directly from our vendors. If our actual product returns significantly exceed our allowances for returns, especially as we expand into new product categories, our revenues and profitability could decrease. In addition, because our allowances are based on historical return rates, the introduction of new merchandise categories, new products, changes in our product mix, or other factors may cause actual returns to exceed return allowances, perhaps significantly. In addition, any policies intended to reduce the number of product returns may result in customer dissatisfaction, increased credit card chargeback activity and fewer repeat customers.

Our ability to offer a broad selection of products at competitive prices is dependent on our ability to maintain existing and build new relationships with manufacturers and vendors. We do not have long- term agreements with our manufacturers or vendors and some of our manufacturers and vendors compete directly with us.

We purchase products for resale both directly from manufacturers and indirectly through distributors and other sources, all of whom we consider our vendors. We have historically offered products on our website from more than 1,000 third-party manufacturers. We do not have any long-term agreements with any of these vendors. Any agreements with vendors governing our purchase of products are generally terminable by either party upon 30 days notice or less. In general, we agree to offer products on our website and the vendors agree to provide us with information about their products and honor our customer service policies. If we do not maintain relationships with vendors on acceptable terms, including favorable product pricing and vendor consideration, we may not be able to offer a broad selection of products or continue to offer products at competitive prices, and customers may choose not to shop at our website. In addition, some vendors may decide not to offer particular products for sale on the Internet, and others may avoid offering their new products to retailers like us who offer a mix of close-out and recertified products in addition to new products. From time to time, vendors may terminate our right to sell some or all of our products, change the applicable terms and conditions of sale or reduce or discontinue the incentives or vendor consideration that they offer. Any such termination or the implementation of such changes could have a negative impact on our operating results. Additionally, some products are subject to manufacturer or distributor allocation, which limits the number of units of those products that are available to us and other resellers.

In particular, our business is dependent on sales of Hewlett Packard (HP) and HP-related products, which represented approximately 52% of eCOST s net revenues (12% of consolidated net revenues) in the six months ended June 30, 2007. Sales of these products in the five month period ended June 30, 2006 were 31% and 7% of eCOST s net revenues and consolidated net revenues, respectively. If our ability to purchase direct from HP is terminated or restricted, or if the demand for HP and HP-related products declines, our business will be materially adversely affected.

We are dependent on the success of our advertising and marketing efforts, which are costly and may not achieve desired results, and on our ability to attract customers on cost-effective terms.

Our revenues depend on our ability to advertise and market our products effectively. Increases in the costs of advertising and marketing, including costs of online advertising, paper and postage costs, costs and fees of third-party service providers and the costs of complying with applicable regulations, may limit our ability to advertise and market our business without impacting our profitability. If our advertising and marketing efforts prove ineffective or do not produce a sufficient level of sales to cover their costs, or if we decrease our advertising or marketing activities due to increased costs, restrictions enacted by regulatory agencies or for any other reason, our revenues and profit margins may decrease. Our success depends on our ability to attract customers on cost-effective terms. We have relationships with online services, search engines, shopping engines, directories and other websites and e-commerce businesses through which we provide advertising banners and other links that direct customers to our website. We expect to rely on these relationships as significant sources of traffic to our website and to generate new customers. If we are unable to develop or maintain these relationships on acceptable terms, our ability to attract new customers on a cost-effective basis could be harmed. In addition, certain of our existing online marketing agreements require us to pay fixed placement fees or fees for directing visits to our eCOST website, neither of which may convert into sales.

Because we experience seasonal fluctuations in our revenues, our quarterly results may fluctuate.

Our business is moderately seasonal, reflecting the general pattern of peak sales for the retail industry during the holiday shopping season. Typically, a larger portion of our revenues occur during the first and fourth fiscal quarters. We believe that our historical revenue growth makes it difficult to predict the effect of seasonality on our future revenues and results of operations. In anticipation of increased sales activity during the first and fourth quarter, we incur additional expenses, including higher inventory and staffing costs. If sales for the first and fourth quarter do not meet anticipated levels, then increased expenses may not be offset which could decrease our profitability. If we were to experience lower than expected sales during its first or fourth quarter, for any reason, it would decrease our profitability.

Our business may be harmed by fraudulent activities on our website.

We have received in the past, and anticipate that we will receive in the future, communications from customers due to purported fraudulent activities on our eCOST website. Negative publicity generated as a result of fraudulent conduct by third parties could damage our reputation and diminish the value of our brand name. Fraudulent activities on our eCOST website could also subject us to losses. We expect to continue to receive requests from customers for reimbursement due to purportedly fraudulent activities or threats of legal action if no reimbursement is made.

If we do not successfully expand our eCOST website and processing systems to accommodate higher levels of traffic and changing customer demands, we could lose customers and our revenues could decline.

To remain competitive, we must continue to enhance and improve the functionality and features of our website. If we fail to upgrade our website in a timely manner to accommodate higher volumes of traffic, our website performance could suffer and we may lose customers. The Internet and the e-commerce industry are subject to rapid technological change. If competitors introduce new features and website enhancements embodying new technologies, or if new industry standards and practices emerge, our existing eCOST website and systems may become obsolete or unattractive. Developing our eCOST website and other systems entails significant technical and business risks. We may face material delays in introducing new services, products and enhancements. If this happens, customers may forgo the use of our eCOST website and use those of our competitors. We may use new technologies ineffectively, or we may fail to adapt our website, transaction processing systems and computer network to meet customer requirements or emerging industry standards.

If we fail to successfully expand our merchandise categories and product offerings in a cost-effective and timely manner, our reputation and the value of our new and existing brands could be harmed, customer demand for our products could decline and our profit margins could decrease.

We have generated the substantial majority of our revenues during the past five years from the sale of computer hardware, software and accessories and consumer electronics products. We launched several new product categories, including digital imaging, watches and jewelry, housewares, DVD movies, video games and cellular/wireless. We cannot predict whether our merchandising platform can be successfully applied to other product categories. In addition, expansion of our business strategy into new product categories may require us to incur significant marketing expenses, develop relationships with new vendors and comply with new regulations. We may lack the necessary expertise in a new product category to realize the expected benefits of that new category. These requirements could strain managerial, financial and operational resources. Additional challenges that may affect our ability to expand into new product categories include our ability to:

- establish or increase awareness of new brands and product categories;
- acquire, attract and retain customers at a reasonable cost;
- achieve and maintain a critical mass of customers and orders across all product categories;
- attract a sufficient number of new customers to whom new product categories are targeted;
- successfully market new product offerings to existing customers;
- maintain or improve gross margins and fulfillment costs;
- attract and retain vendors to provide an expanded line of products to customers on terms that are acceptable; and
- manage inventory in new product categories.

We cannot be certain that we will be able to successfully address any or all of these challenges in a manner that will enable us to expand our business into new product categories in a cost-effective or timely manner. If our new categories of products or services are not received favorably, or if our suppliers fail to meet our customers expectations, our results of operations would suffer and our reputation and the value of the applicable new brand and other brands could be damaged. The lack of market acceptance of our new product categories or inability to generate satisfactory revenues from any expanded product categories to offset our cost could harm our business.

Credit card fraud could materially adversely affect our business.

We do not currently carry insurance against the risk of credit card fraud, so the failure to adequately control fraudulent credit card transactions could reduce our revenues and gross margin. We may suffer losses as a result of orders placed with fraudulent credit card data even though the associated financial institution approved payment of the orders. Under current credit card practices, we may be liable for fraudulent credit card transactions because we did not obtain a cardholder s signature. If we are unable to detect or control credit card fraud, or if credit card companies require more burdensome terms, refuse to accept credit card charges or assess financial penalties, our business could be materially adversely affected.

If we are unable to provide satisfactory customer service, we could lose customers.

Our ability to provide satisfactory levels of customer service depends, to a large degree, on the efficient and uninterrupted operation of our customer service operations. Any material disruption or slowdown in our order processing systems resulting from labor disputes, telephone or Internet failures, power or service outages, natural disasters or other events could make it difficult or impossible to provide adequate

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customer service and support. If we are unable to continually provide adequate staffing and training for our customer service operations, our reputation could be seriously harmed and we could lose customers. Because our success depends in large part on keeping our customers satisfied, any failure to provide high levels of customer service would likely impair our reputation and decrease our revenues.

We may not be able to compete successfully against existing or future competitors.

The market for online sales of the products we offer is intensely competitive and rapidly evolving. We principally compete with a variety of online retailers, specialty retailers and other businesses that offer products similar to or the same as our products. Increased competition is likely to result in price reductions, reduced revenue and gross margins and loss of market share. We expect competition to intensify in the future because current and new competitors can enter the market with little difficulty and can launch new websites at a relatively low cost. In addition, some of our product vendors have sold, and continue to intensify their efforts to sell, their products directly to customers. We currently or potentially compete with a variety of businesses, including:

- other multi-category online retailers and liquidation e-tailers;
- online discount retailers of computer and consumer electronics merchandise such as Buy.com, NewEgg and TigerDirect;
- consumer electronics and office supply superstores such as Best Buy, Circuit City, CompUSA, Office Depot, OfficeMax and Staples; and
- manufacturers such as Apple, Dell, Gateway, Hewlett-Packard and IBM, that sell directly to customers.

Many of the current and potential competitors described above have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. In addition, online retailers may be acquired by, receive investments from or enter into other commercial relationships with larger, well-established and well-financed companies. Some of our competitors may be able to secure products from manufacturers or vendors on more favorable terms, devote greater resources to marketing and promotional campaigns, adopt more aggressive pricing or inventory availability policies and devote substantially more resources to website and systems development than we are able to.

If the protection of our trademarks and proprietary rights is inadequate, our eCOST brand and reputation could be impaired and we could lose customers.

We have five trademarks and/or service marks that we consider to be material to the successful operation of our business: eCOST®, eCOST.com®, eCOST.com Your Online Discount Superstore! , Bargain Countdown® and Bargain Countdown Platinum Club . We currently use all of these marks in connection with telephone, mail order, catalog, and online retail services. We also have several additional pending trademark applications. We rely on trademark and copyright law, trade secret protection and confidentiality agreements with our employees, consultants, suppliers and others to protect our proprietary rights. Our applications may not be granted, and we may not be able to secure significant protection for our service marks or trademarks. Our competitors or others could adopt trademarks or service marks similar to our marks, or try to prevent us from using our marks, thereby impeding our ability to build brand identity and possibly leading to customer confusion. Any claim by another party against us for customer confusion caused by use of our trademarks or service marks, or our failure to obtain registrations for our marks, could negatively affect our competitive position and could cause us to lose customers.

We have also filed an application with the U.S. Patent and Trademark Office for patent protection for our proprietary Bargain Countdown(TM) technology. We may not be granted a patent for this technology and may not be able to enforce our patent rights if our competitors or others use infringing technology. If this occurs, our competitive position, revenues and profitability could be negatively affected.

Effective trademark, service mark, patent, copyright and trade secret protection may not be available in every country in which we will sell our products and offer our services. In addition, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. Therefore, we may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon or otherwise decrease the value of our trademarks and other proprietary rights.

If we are unable to protect or preserve the value of our trademarks, copyrights, trade secrets or other proprietary rights for any reason, our competitive position could be negatively affected and we could lose customers.

We also rely on technologies that we license from related and third parties. These licenses may not continue to be available to us on commercially reasonable terms, or at all, in the future. As a result, we may be required to develop or obtain substitute technology of lower quality or at greater cost, which could negatively affect our competitive position, cause us to lose customers and decrease our profitability.

If third parties claim we are infringing their intellectual property rights, we could incur significant litigation costs, be required to pay damages, or change our business or incur licensing expenses.

Third parties have asserted, and may in the future assert, that our business or the technologies we use infringe on their intellectual property rights. As a result, we may be subject to intellectual property legal proceedings and claims in the ordinary course of business. We cannot predict whether third parties will assert claims of infringement in the future or whether any future claims will prevent us from offering popular products or services. If we are found to infringe, we may be required to pay monetary damages, which could include treble damages and attorneys fees for any infringement that is found to be willful, and either be enjoined or required to pay ongoing royalties with respect to any technologies found to infringe. Further, as a result of infringement claims either against us or against those who license technology to us, we may be required, or deem it advisable, to develop non-infringing technology, which could be costly and time consuming, or enter into costly royalty or licensing agreements. Such royalty or licensing agreements, if required, may be unavailable on terms that are acceptable, or at all. If a third party successfully asserts an infringement claim against us and we are enjoined or required to pay monetary damages or royalties or we are unable to develop suitable non-infringing alternatives or license the infringed or similar technology on reasonable terms on a timely basis, our business, results of operations and financial condition could be materially harmed.

On July 12, 2004, we received correspondence from MercExchange LLC alleging infringement of its U.S. patents relating to e-commerce and offering to license its patent portfolio to eCOST. On July 15, 2004, we received a follow-up letter from MercExchange specifying which of eCOST s technologies it believes infringe certain of its patents, alone or in combination with technologies provided by third parties. Some of those patents are currently being litigated by third parties, and we are not involved in those proceedings. In addition, three of the four patents identified by MercExchange are under reexamination at the U.S. Patent and Trademark Office, which may or may not result in the modification of the claims. In the July 15(th) letter, MercExchange also advised that it has a number of applications pending for additional patents. MercExchange has filed lawsuits alleging infringement of some or all of its patents against third parties, resulting in settlements or verdicts in favor of MercExchange. At least one such verdict was appealed to the United States Court of Appeals for the Federal Circuit and was affirmed in part. Recently, the Supreme Court reversed the ruling by the United States Court of Appeals for the Federal Circuit Court requiring that an injunction must be issued in that case. Based on our investigation of this matter to date, we believe that our current eCOST operations do not infringe any valid claims of the patents identified by MercExchange in these letters.

We may be liable for misappropriation of our customers personal information.

Data security laws are becoming more stringent in the United States and abroad. Third parties are engaging in increased cyber attacks against companies doing business on the Internet and individuals are increasingly subjected to identity and credit card theft on the Internet. If third parties or unauthorized employees are able to penetrate our network security or otherwise misappropriate its customers personal information or credit card information, or if we give third parties or our employees improper access to customers personal information or credit card information, we could be subject to liability. This liability could include claims for unauthorized purchases with credit card information, impersonation or other similar fraud claims. This liability could also include claims for other misuses of personal information, including unauthorized marketing purposes. Liability for misappropriation of this information could decrease our profitability. In such circumstances, we also could be liable for failing to provide timely notice of a data security breach affecting certain types of personal information. In addition, the Federal Trade Commission and state agencies have brought numerous enforcement actions against Internet companies for alleged deficiencies in those companies privacy and data security practices, and they may continue to bring such actions. We could incur additional expenses if new regulations regarding the collection, use or storage of personal information are introduced or if government agencies investigate our privacy or security practices.

We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary to effect secure transmission of sensitive customer information such as customer credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography or other events or developments may result in a compromise or breach of the algorithms that we use to protect customer transaction data. If any such compromise of security were to occur, it could subject us to liability, damage our reputation and diminish the value of our brand-name. A party who is able to circumvent the security measures could misappropriate proprietary information or cause interruptions in operations. We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches. Our security measures are designed to prevent security breaches, but our failure to prevent such security breaches could subject us to liability, damage our reputation and diminish the value of our brand-name.

Moreover, for the convenience of our customers, we provide non-secured channels for customers to communicate. Despite the increased security risks, customers may use such channels to send personal information and other sensitive data. In addition, phishing incidents are on the rise. Phishing involves an online company s customers being tricked into providing their credit card numbers or account information to someone pretending to be the online company s representative. Such incidents have recently given rise to litigation against online companies for failing to take sufficient steps to police against such activities by third parties, and may discourage customers from using online services.

We may be subject to product liability claims that could be costly and time consuming.

We sell products manufactured and distributed by third parties, some of which may be defective. If any product that we sell were to cause physical injury or damage to property, the injured party or parties could bring claims against us as the retailer of the product. Our insurance coverage may not be adequate to cover every claim that could be asserted. If a successful claim were brought against us in excess of its insurance coverage, it could expose us to significant liability. Even unsuccessful claims could result in the expenditure of funds and management time and could decrease profitability.

If eCOST is unable to generate projected cash flows, it could trigger future impairment charges related to eCOST s intangible assets.

The valuation of intangible assets related to eCOST is dependent upon, among other things, eCOST s ability to generate projected cash flows for its business. In the event eCOST is unable to meet such projections, we may be required under current accounting rules to record an impairment charge in connection with the write-down of such intangibles.

Risks Related to Our eCOST Online Retailer Operating Segment s Industry

Additional sales and use taxes could be imposed on past or future sales of our products or other products sold on our eCOST website, which could adversely affect our revenues and profitability.

In accordance with current industry practice and our interpretation of applicable law, we collect and remit sales taxes only with respect to physical shipments of goods into states where we have a physical presence. If any state or other jurisdiction successfully challenges this practice and imposes sales and use taxes on orders on which we do not collect and remit sales taxes, we could be exposed to substantial tax liabilities for past sales and could suffer decreased sales in that state or jurisdiction in the future. In addition, a number of states, as well as the U.S. Congress, have been considering various legislative initiatives that could result in the imposition of additional sales and use taxes on Internet sales. If any of these initiatives are enacted, we could be required to collect sales and use taxes in states where we do not have a physical presence. Future changes in the operation of our business also could result in the imposition of additional sales and use tax obligations. The imposition of additional sales and use taxes on past or future sales could adversely affect our revenues and profitability.

Existing or future government regulation could expose us to liabilities and costly changes in our

business operations, and could reduce customer demand for our products.

We are subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet and e-commerce. Such existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, user privacy, marketing and promotional practices, database protection, pricing, content, copyrights, distribution, electronic contracts, email and other communications, consumer protection, product safety, the provision of online payment services, intellectual property rights, unauthorized access (including the Computer Fraud and Abuse Act), and the characteristics and quality of products and services. It is unclear how existing laws governing issues such as property ownership, sales and other taxes, libel, trespass, data mining and collection, and personal privacy apply to the Internet and e-commerce. Unfavorable resolution of these issues may expose us to liabilities and costly changes in our business operations, and could reduce customer demand. The growth and demand for online commerce has and may continue to result in more stringent consumer protection laws that impose additional compliance burdens on online companies. For example, California law requires notice to California customers if certain personal information about them is obtained by an unauthorized person, such as a computer hacker. These consumer protection laws could result in substantial compliance costs and could decrease profitability.

Laws or regulations relating to privacy and data protection may adversely affect the growth of our eCOST Internet business or our marketing efforts.

We are subject to increasing regulation relating to privacy and the use of personal user information. For example, we are subject to various telemarketing and anti-spam laws that regulate the manner in which it may solicit future suppliers and customers. Such regulations, along with increased governmental or private enforcement, may increase the cost of growing the business. In addition, several jurisdictions, including California, have adopted legislation limiting the uses of personal user information gathered online or require online services to establish privacy policies. Pursuant to the Children s Online Privacy Protection Act, the Federal Trade Commission has adopted regulations regarding the collection and use of personal identifying information obtained from children under 13 years of age. Increasingly, federal, state and foreign laws and regulations extend online privacy protection to adults. Moreover, in jurisdictions where we do business, there is a trend toward requiring companies to establish procedures to notify users of privacy and security policies, to obtain prior consent from users for the collection, use and disclosure of personal information (even disclosure to affiliates), and to provide users with the ability to access, correct and delete personal information stored by companies. These data protection regulations and enforcement efforts may restrict our ability to collect, use or transfer demographic and personal information from users, which could be costly or harm marketing efforts. Further, any violation of privacy or data protection laws and regulations may subject us to fines, penalties and damages, as well as harm to our reputation, which could decrease our revenues and profitability.

Risks Related to Our Stock

The market price of our common stock may be volatile. You may not be able to sell your shares at or above the price at which you purchased such shares.

The trading price of our common stock may be subject to wide fluctuations in response to quarter-to-quarter fluctuations in operating results, announcements of material adverse events, general conditions in our industry or the public marketplace and other events or factors. In addition, stock markets have experienced extreme price and trading volume volatility in recent years. This volatility has had a substantial effect on the market prices of securities of many technology related companies for reasons frequently unrelated to the operating performance of the specific companies. These broad market fluctuations may adversely affect the market price of our common stock. In addition, if our operating results differ from our announced guidance or the expectations of equity research analysts or investors, the price of our common stock could decrease significantly.

Our stock price could decline if a significant number of shares become available for sale.

As of June 30, 2007, we had issued and outstanding 601,190 warrants to purchase common stock (having a weighted average exercise price of $2.29 per share). In addition, as of June 30, 2007, we have an

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aggregate of 6,470,917 stock options outstanding to employees, directors and others with a weighted average exercise price of $1.24 per share. The shares of common stock that may be issued upon exercise of these warrants and options may be resold into the public market. Sales of substantial amounts of common stock in the public market as a result of the exercise of these warrants or options, or the perception that future sales of these shares could occur, could reduce the market price of our common stock and make it more difficult to sell equity securities in the future.

Our common stock could be delisted from the Nasdaq Capital Market which would cause us to become ineligible to use Form S-3 for the registration of the resale of our securities held by certain of our security holders.

Historically, the price of our common stock has traded below $1.00 per share. If the price of our common stock declines below $1.00 per share for 30 consecutive trading days, we may fail to meet Nasdaq s maintenance criteria, which may result in the delisting of our common stock from the Nasdaq Capital Market.

In the event of such delisting, trading, if any, in our common stock may then continue to be conducted in the non-Nasdaq over-the-counter market in what are commonly referred to as the electronic bulletin board and the pink sheets. As a result, an investor may find it more difficult to dispose of or obtain accurate quotations as to the market value of our common stock. In addition, we would be subject to a Rule promulgated by the SEC that, if we fail to meet criteria set forth in such Rule, imposes various practice requirements on broker-dealers who sell securities governed by the Rule to persons other than established customers and accredited investors. For these types of transactions, the broker-dealer must make a special suitability determination for the purchaser and have received the purchaser s written consent to the transactions prior to the sale. Consequently, the Rule may have a material adverse effect on the ability of broker-dealers to sell our securities, which may materially affect the ability of shareholders to sell our securities in the secondary market.

A delisting from the Nasdaq Capital Market will also make us ineligible to use Form S-3 to register the sale of shares of our common stock or to register the resale of our securities held by certain of our security holders with the SEC, thereby making it more difficult and expensive for us to register our common stock or other securities and raise additional capital. We are a party to certain registration rights agreements, which require us to maintain the effectiveness of registration statements relating to the resale of shares of common stock issuable upon the exercise of outstanding warrants. If we are ineligible to use Form S-3, we will need to file new registration statements on some other permitted Form and maintaining the effectiveness of such registration statements may be more difficult, expensive and time-consuming.

Our certificate of incorporation, our bylaws, our shareholder rights plan and Delaware law make it difficult for a third party to acquire us, despite the possible benefit to our shareholders.

Provisions of our certificate of incorporation, our bylaws, our shareholder rights plan and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. For example, our certificate of incorporation provides for a classified board of directors, meaning that only approximately one-third of our directors may be subject to re-election at each annual stockholder meeting. Our certificate of incorporation also permits our Board of Directors to issue one or more series of preferred stock, which may have rights and preferences superior to those of the common stock. The ability to issue preferred stock could have the effect of delaying or preventing a third party from acquiring us. We have also adopted a shareholder rights plan. These provisions could discourage takeover attempts and could materially adversely affect the price of our stock. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit large shareholders from consummating a merger with, or acquisition of us. These provisions may prevent a merger or acquisition that would be attractive to shareholders and could limit the price that investors would be willing to pay in the future for our common stock.

There are limitations on the liabilities of our directors and executive officers.

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Pursuant to our bylaws and under Delaware law, our directors are not liable to us or our shareholders for monetary damages for breach of fiduciary duty, except for liability for breach of a director s duty of loyalty, acts or omissions by a director not in good faith or which involve intentional misconduct or a knowing violation of law, or any transaction in which a director has derived an improper personal benefit.

ITEM 2. Changes in Securities and Use of Proceeds

None

ITEM 3. Defaults Upon Senior Securities

None

ITEM 4. Submission of Matters to a Vote of Security Holders

On June 15, 2007, the Company held its Annual Meeting of Stockholders. The following matters were acted upon and votes cast or withheld:

1. Election of Director:

   Dr. Neil W. Jacobs For: 41,189,905 Withheld: 1,435,463

2. To grant the Board of Directors discretionary authority to amend the Company s Amended and Restated Certificate of Incorporation to effect a reverse stock split:

   For: 40,243,368 Against: 2,331,510 Abstentions: 50,489

3. Approval of the Amendments to the Company s Non-Employee Director Stock Option Plan:

   For: 12,183,520 Against: 3,641,556 Abstentions: 99,301 No Vote: 26,700,991

4. Appointment of KPMG LLP as auditors for the fiscal year ending December 31, 2007:

   For: 42,386,882 Against: 163,501 Abstentions: 74,986

ITEM 5. Other Information

None.

ITEM 6. Exhibits

a) Exhibits:

Exhibit No.	**Description of Exhibits**
3.1(1)	Amended and Restated Certificate of Incorporation
3.2(1)	Amended and Restated Bylaws
31.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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(1) Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657) and Annual Report on Form 10-K for the Fiscal Year ended December 31, 2005 filed on March 31, 2006.

(2) Incorporated by reference from PFSweb, Inc. Form 10-K for the year ended December 31, 2006.

* Filed herewith

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 14, 2007

PFSweb, Inc.

By: /s/ Thomas J. Madden
Thomas J. Madden
Chief Financial Officer,
Chief Accounting Officer,
Executive Vice President

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