BLUEFLY INC
Form 10-K
March 28, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission File Number: 001-14498

BLUEFLY, INC.
(Name of registrant as specified in its charter)

Delaware	13-3612110
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

42 West 39th Street, New York, NY	10018
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number: (212) 944-8000

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $.01 per share	The Nasdaq Stock Market LLC

Securities registered under Section 12(g) of the Exchange Act: None

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 [X] No [ ]

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer or a smaller reporting company. See the definitions of "larger accelerated filer," "accelerated filer" and

"smaller reporting company" in Rule 12b-2 of the Exchange Act.
(Check one):

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [ ]
Smaller reporting company [X]
(Do not check if a smaller reporting company)

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

As of March 24, 2008, there were 132,899,844 shares of Common Stock, $.01 par value, of the registrant outstanding. The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 29, 2007, based upon the last sale price of such equity reported on the Nasdaq Capital Market, was approximately $18.7 million.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part III of Form 10-K is incorporated by reference to the Registrant's proxy statement for the 2008 Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission.

BLUEFLY, INC.
ANNUAL REPORT ON FORM 10-K
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PART I

Special Note Regarding Forward-Looking Statements and Associated Risks

This Annual Report contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "project," "will be," "will continue," "will likely result," or words or phrases of similar meaning. Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the forward-looking statements ("Cautionary Statements"). The risks and uncertainties include, but are not limited to those matters addressed herein under "Risk Factors." All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the Cautionary Statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 1. Description of Business

General

Bluefly, Inc. is a leading online retailer of designer brands, fashion trends and superior value. During 2007, we offered over 50,000 different styles for sale in categories such as men's, women's and accessories as well as house and home accessories from over 350 brands at discounts up to 75% off retail value. We launched the Bluefly.com Web site (the "Web site") in September 1998. Since its inception, www.bluefly.com has served over one million customers and shipped to over 13 countries.

Our common stock is listed on the Nasdaq Capital Market under the symbol "BFLY" and we are incorporated in Delaware. Our executive offices are located at 42 West 39th Street, New York, New York 10018, and our telephone number is (212) 944-8000. Our Internet address is www.bluefly.com. We make available, free of charge, through our Web site, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

In this report, the terms "we," "us," "Bluefly" and the "Company" refer to Bluefly, Inc. and its predecessors and subsidiaries, unless the context indicates otherwise.

Recent Developments

In March 2008, we entered into an agreement (the "Commitment") with affiliates of Soros Fund Management LLC ("Soros") and private funds associated with Maverick Capital, Ltd. ("Maverick") pursuant to which they agreed to provide up to $3 million of debt financing to us, on a standby basis, during the next year, provided that the commitment amount will be reduced by the gross proceeds of any equity financing consummated during the year. We can draw down debt in one or more tranches, provided that our cash balances are less than $1 million at the time of any draw down. The draw downs will be evidenced by subordinated convertible notes (the "Subordinated Notes") that have a term expiring on the later of June 26, 2011 and three years from the date of the issuance of the Subordinated Notes and bear interest at the rate of 8% per annum, compounded annually. Interest is payable upon maturity or conversion. The Subordinated Notes are convertible (subject to stockholder approval to the extent required by the NASDAQ Capital Market), at the holder's option (a) into equity securities that the Company might issue in any subsequent round of financing at a price that was equal to the lowest price per share paid by any investor in such subsequent round of financing or (b) into Common Stock at a price per share equal to the market price (as defined in the Subordinated Notes) on the date of issuance of the note. In connection with the Commitment, we issued warrants to Soros and Maverick to purchase an aggregate of 525,002 shares of Common Stock at an exercise price equal to the trailing 20-day average stock price on the date of grant.

In March 2008, we amended our credit facility ("Credit Facility") with Wells Fargo Retail Finance, LLC. ("Wells Fargo") to (i) extend the term until July 26, 2011; (ii) change the rate at which interest accrues on the average daily amount under the Credit Facility during the preceding month to a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 3.25% on average excess availability less than $3.0 million and prime rate plus 0.50% or LIBOR plus 3% on average excess availability greater than $3.0 million; (iii) increase the monthly commitment fee on the unused portion of the Credit Facility to 0.50% from 0.35%; (iv) include a servicing fee of $3,333.33 per month; (v) increase the early termination fee to 1% of the revolving credit ceiling, from 0.50% through maturity; and (vi) amend the standby and documentary letter of credit fees to 3.25% and 2.75%,

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respectively on average excess availability less than $3.0 million, and 3.00% and 2.50%, respectively on average excess availability greater than $3.0 million.

In addition, the amendment calls for no revolving credit loans to be made unless the full amount available pursuant to the Subordinated Notes (described above) has been advanced to the Company and is outstanding. In connection with this amendment, we paid Wells Fargo a $35,000 amendment fee. Under the terms of a Subordination and Intercreditor Agreement, dated as of March 26, 2008, Soros and Maverick have the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

On March 13, 2008, our Board of Directors approved a 1-for-10 reverse stock split of our Common Stock. The record date for the reverse stock split is April 3, 2008, and the reverse stock split will be effective as of the close of trading on the same date. On a pre-split basis, we currently have approximately 132 million shares of Common Stock outstanding (excluding treasury shares), which will be reduced to approximately 13.2 million shares as a result of the split. All share numbers in this report are shown on a pre-split basis.

Business Strategy

Our goal is to offer our customers the best designer brands and latest fashion trends at superior values. We offer the same types of on-trend and in-season designer merchandise as are sold in luxury department stores at discounts. Similarly, we are able to offer an upscale shopping experience not available at off-price stores or outlet malls because of our merchandise selection and the presentation and product search capabilities offered by our Web site. The frequent addition of new on-trend products to our site is also key to our marketing strategy, as it gives our shoppers reason to visit the site and encourages them to be loyal and active.

Our business is also designed to provide a compelling value proposition for our suppliers and, in particular, the more than 350 top designer brands that we offer on our Web site. Because we work with our suppliers both at the beginning and throughout the season, we are able to help them manage inventory and cash flow. We also create an environment that is respectful of the brands we sell. Our buyers all have backgrounds in a full price branded retail environment. Our Web site creates a high-end retail environment that offers only the best designer brands and the most current trends. In doing so, we support our vendors' brands, rather than diluting them as traditional off-price channels do.

We do not believe that we can accomplish these goals without using the Internet as a platform. The direct marketing of products that are available in limited quantities and sizes, and that are not replenishable, requires a cost-effective medium that can display a large number of products. We believe print catalogs are not well suited to this task. The paper, printing, mailing and other production costs of a print catalog can be significant and the lead times required to print a catalog make them significantly inflexible in addressing inventory sell outs, price changes and new styles. To work around these limitations, a traditional cataloger typically requires products that are replenishable, available in a full range of sizes and in substantial quantities. Similarly, retailing on television is costly and requires substantial quantities of products that are available in all sizes in order for it to be an economical medium. In addition, the number of items that can be displayed on television is limited, and television does not allow viewers to search for products that interest them.

The Internet, however, can be a far less expensive and far more effective medium. By using the Internet as our platform, the number of items that we offer is not limited by the high costs of printing and mailing catalogs. With the Internet, we can automatically update product images as new products arrive and other items sell out. By using a real-time inventory database, we can create a personalized shopping environment and allow our customers to search for the products that specifically interest them and are available in their size. In addition, we believe that we are able to more economically and consistently maintain an upscale environment through the design of a single online storefront.

We believe that we have created a customer experience that is fundamentally better than that offered by traditional off-price retailers. Similarly, we believe that our upscale atmosphere, professional photography and premium merchandise offering create a superior distribution channel for designers who wish to liquidate their end-of-season and excess merchandise without suffering the brand dilution inherent in traditional off-price channels. Our customer research suggests that this strategy has been successful. For example, respondents to a recent third party study that we commissioned rated us at the level of, or higher than, luxury department stores for assortment, quality and service and rated us much higher for value.

E-Commerce And The Online Apparel Market

The dramatic growth of e-commerce has been widely reported and is expected to

continue. According to "US eCommerce Forecast: 2008 to 2012", published by Forrester Research, Inc., in January 2008, online retail in the United States reached $175

billion in 2007 and is projected to grow to $335 billion by 2012. The apparel, accessories and footwear category for 2007 totaled $22.7 billion and is expected to grow to $41.8 billion by the year 2012.

According to the ComScore Inc., e-commerce non travel retail holiday spending (excluding auctions and large corporate purchases) surpassed $29 billion in 2007 compared to $24.6 billion in 2006, an increase of 19 percent.

Marketing

Our marketing efforts are focused both on acquiring new customers and retaining existing customers. Active Bluefly customers visit the site frequently and purchase from one season to the next at high levels with great predictability. A significant portion of our sales to existing customers are driven by our customer emails, which highlight new promotions and products, and provide special previews to customers who have asked to be included in our email list. In addition, we believe that our sales to existing customers are driven by all aspects of our customer experience, including our Web site design, packaging, delivery and customer service.

Prior to 2005, we acquired new customers primarily through online advertising, word-of-mouth, sweepstakes and our affiliate program. In September 2005, faced with low awareness numbers, we began a national advertising campaign that featured both print and television. Over the past two and a half years we have increased awareness by targeting general advertising efforts to a more fashion focused customer. In 2007 we further refined our marketing strategy by aligning ourselves with entertainment properties, such as BravoTV.com and Project Runway.

Merchandising

We buy merchandise directly from designers as well as from other third party indirect resources. Currently, we offer products from more than 350 name brand designers. We believe that we have been successful in developing vendor relationships, in part because we have devoted substantial resources to establishing Bluefly.com as a high-end retail environment. We are committed to displaying all of our merchandise in an attractive manner, offering superior customer service and gearing all aspects of our business towards creating a better channel for top designers.

Warehousing And Fulfillment

When we receive an order, the information is transmitted to our third party warehouse and fulfillment center, where the items included in the order are picked, packed and shipped directly to the customer. Our inventory database is updated on a real-time basis, allowing us to display on our Web site only those styles, sizes and colors of product available for sale. During the third quarter of 2007, we completed our transition to a new third party distribution center located in Ohio. Over the long term, we expect the transition to the new Distribution center to improve customer service and increase efficiencies, however, there can be no assurance that this will happen. See, "Risk Factor - Our Business Has Been Impacted by Issues Related to Our Transition to a New Third Party Distribution Center."

Customer Service

We believe that a high level of customer service and support is critical to differentiating ourselves from traditional off-price retailers and maximizing customer acquisition and retention efforts. Our customer service effort starts with our Web site, which is designed to provide an intuitive shopping experience. An easy-to-use help center is available on the Web site and is designed to answer many of our customers' most frequently asked questions. For customers who prefer e-mail, chat or telephone assistance, customer service representatives are available seven days a week to provide assistance. We utilize customer representatives from a third party call center that has a team dedicated to our business. We also maintain a team of premiere representatives in our New York office, who provide special services and assist in the training and management of the other representatives. To ensure that customers are satisfied with their shopping experience, we generally allow returns for any reason within 90 days of the sale for a full refund.

In January 2007, we were awarded the "E-tailing Excellence Award" from the e-tailing group for the second consecutive year. This award recognizes online merchants who excel in customer service.

Technology

We have implemented a broad array of state-of-the-art technologies that facilitate Web site management, complex database search functionality, customer interaction and personalization, transaction processing, fulfillment and customer service functionality. Such technologies include a combination of proprietary technology and commercially available, licensed

technology. To address the critical issues of privacy and security on the Internet, we incorporate, for transmission of confidential personal information between customers and our Web server, Secure Socket Layer Technology ("SSL") such that all data is transmitted via a 128-bit encrypted session. The computer and communications equipment on which our Web site is hosted are currently located at a third party co-location facility in New York.

In September 2006, we entered into agreements with Art Technology Group, Inc. ("ATG"), pursuant to which we will license certain technology from ATG to be used as a platform for future versions of our Web site. We are in the process of developing an improved version of our Web site based on ATG software. The new version of our Web site is expected to launch in the second half of 2008/early 2009 and will replace the older version. The launch of the new Web site will involve the use of significant internal and external resources. Certain costs related to the development of the new Web site will be capitalized and amortized over a 36-month period.

We expect that the more robust tools provided by the upgraded Web site will allow us to better create and manage, and measure the performance of, on-site marketing promotions. In addition, we believe that the new Web site will provide a more efficient platform from which to scale our technology infrastructure should any future growth in our business dictate such a need. There can be no assurance that the new Web site will have a positive effect on our business. See, "Risk Factor - The Implementation Of A New Web site May Place A Significant Strain On Our Resources and Could Result in Start-Up Performance Issues."

Competition

E-commerce generally, and, in particular, the online retail apparel and fashion accessories market, is a relatively dynamic, high-growth market. Our competition for online customers comes from a variety of sources, including existing land-based retailers that are using the Internet to expand their

channels of distribution, established Internet companies and less established companies. In addition, our competition for customers comes from traditional direct marketers, designer brands that may attempt to sell their products directly to consumers through the Internet and land-based off-price retail stores, which may or may not use the Internet in the future to grow their customer base. Many of these competitors have longer operating histories, significantly greater resources, greater brand recognition and more firmly established supply relationships. Moreover, we expect additional competitors to emerge in the future.

We believe that the principal competitive factors in our market include: brand recognition, merchandise selection, price, convenience, customer service, order delivery performance and site features.

Intellectual Property

We rely on various intellectual property laws and contractual restrictions to protect our proprietary rights in services and technology, including confidentiality, invention assignment and nondisclosure agreements with employees and contractors. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without our authorization. In addition, we pursue the registration of our trademarks and service marks in the U.S. and internationally and the registration of our domain name and variations thereon. However, effective intellectual property protection may not be available in every country in which the services are made available online.

We rely on technologies that we license from third parties. These licenses may not continue to be available to us on commercially reasonable terms in the future. As a result, we may be required to obtain substitute technology of lower quality or at greater cost, which could materially adversely affect our business, financial condition, results of operations and cash flows.

We do not believe that our business, sales policies or technologies infringe the proprietary rights of third parties. However, third parties have in the past and may in the future claim that our business, sales policies or technologies infringe their rights. We expect that participants in the e-commerce market will be increasingly subject to infringement claims as the number of services and competitors in the industry grows. Any such claim, with or without merit, could be time consuming, result in costly litigation or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements might not be available on terms acceptable to us, or at all. As a result, any such claim of infringement against us could have a material adverse effect upon our business, financial condition, results of operations and cash flows.

Governmental Approvals And Regulations

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. We are not aware of any permits or licenses that are required in order for us, generally, to sell apparel and fashion accessories on the Internet, although licenses are sometimes required to sell products made from specific materials. In addition, permits or licenses may be required

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from international, federal, state or local governmental authorities to operate or to sell certain other products on the Internet in the future. No assurances can be given that we will be able to obtain such permits or licenses. We may be required to comply with future national and/or international legislation and

statutes regarding conducting commerce on the Internet in all or specific countries throughout the world. No assurance can be made that we will be able to comply with such legislation or statutes. Our Internet operations are not currently impacted by federal, state, local and foreign environmental protection laws and regulations.

Employees

As of March 17, 2008, we had 104 full-time employees and 1 part-time employee, as compared to 95 full-time and 1 part-time employees as of March 17, 2007. None of our employees are represented by a labor union, and we consider our relations with our employees to be good.

Item 1A. Risk Factors

We Have A History Of Losses And Expect That Losses Will Continue In The Future. As of December 31, 2007, we had an accumulated deficit of $131,826,000. We incurred net losses of $15,829,000, $12,193,000 and $3,820,000 for the years ended December 31, 2007, 2006 and 2005, respectively. We have incurred substantial costs to develop our Web site and infrastructure, and build our customer file and brand awareness. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore may continue to incur substantial operating losses for at least the next year. Our ability to become profitable depends on our ability to generate and sustain substantially higher net sales while maintaining reasonable expense levels, both of which are uncertain. If we do achieve profitability, we cannot be certain that we would be able to sustain or increase profitability on a quarterly or annual basis in the future.

Soros, Maverick And Prentice Each Own A Large Amount Of Our Stock And Therefore Can Exert Significant Influence Over Our Management And Policies. As of March 21, 2008, Soros owned, in the aggregate, approximately 38% of our Common Stock. Maverick and investment entities and accounts managed and advised by Prentice Capital Management, LP ("Prentice") each owned approximately 23% of our Common Stock. We entered into a voting agreement with Soros, Maverick and Prentice (the "Voting Agreement"), pursuant to which Soros has the right to designate three designees to our Board of Directors, and Maverick and Prentice each have the right to designate one designee. The Voting Agreement also provides that one designee of Soros and the designee of each of Maverick and Prentice have the right to serve on the Compensation Committee and the Governance and Nominating Committee of the Board of Directors. If we establish an Executive Committee, the designees of Soros, Maverick and Prentice will be entitled to serve on such committee. In March 2008, we entered into the Commitment pursuant to which Soros and Maverick agreed to provide up to $3 million of debt financing to us during the next year. Draw downs on the Commitment will be evidenced by the Subordinated Notes, which are convertible (subject to stockholder approval to the extent required by the NASDAQ Capital Market), at the holder's option, into shares of our Common Stock. To the extent we issue Subordinated Notes to Soros and Maverick that are subsequently converted, the ownership interests of Soros and Maverick will be increased. See "Description of Business - Recent Developments."

In view of their large percentage of ownership, Soros, Maverick and Prentice each have the ability to exert significant influence over our management and policies, such as the election of our directors, the appointment of new management and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation, a sale of all or substantially all of our assets or a merger.

We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds. We may need additional financing to effect our business plan

and accelerate our customer acquisition. The Company's ability to meet its obligations in the ordinary course of business is dependent upon its ability to establish profitable operations or raise additional financing through public or private debt or equity financing, or other sources of financing to fund operations. In March 2008, we entered into the Commitment pursuant to which Soros and Maverick agreed to provide up to $3 million in debt financing to us during the next year. The Company believes that its existing resources, together with working capital should be sufficient to satisfy its cash requirements through at least December 31, 2008. The Company may seek additional equity or debt capital to maximize the growth of its business or if anticipated operating results are not achieved. The environment for raising investment capital has been difficult and there can be no assurance that additional financing or other capital will be available upon terms acceptable to us, or at all. In the event that we are unable to obtain additional financing, if needed, we could be forced to decrease expenses that we believe are necessary for us to realize on our long-term prospects for growth and profitability and/or liquidate inventory in order to generate cash. Moreover, any additional equity financing that we may raise could result in significant dilution of the existing holders of common stock. See "Description of Business- Recent Developments."

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Our Lender Has Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility. Under the terms of our loan facility, our lender has a first priority lien on substantially all of our assets, including our cash balances. If we default under the loan facility, our lender would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the loan facility.

Our Business Has Been Impacted by Issues Related to Our Transition to a New Third Party Distribution Center. During the third quarter of 2007, we completed our transition to a new third party distribution center. In connection with this transition, we incurred incremental expenses of approximately $721,000 in costs directly related to the move (including trucking, labor, insurance, etc.). We took additional charges of approximately $550,000 against our inventory during the third quarter of 2007, based on the reconciliation of inventory that we normally perform in connection with each quarter's close. We believe that the charges that were taken were sufficient to cover any loss of inventory resulting from the transition. We have worked with the distribution center to implement necessary changes to their inventory reporting systems as a result of the full physical inventory that was performed in January 2008, following the end of the Holiday sales and returns cycle. We believe that significant operational issues related to the move have been resolved. Start-up issues associated with the transition to the new distribution center also resulted in certain cancelled orders and other incremental costs such as expedited shipping costs. During the period from June 2007 through mid September of 2007 a portion of the Company's inventory was not available for sale. This had a significant impact on the offering to the consumer and hence the ultimate sales recognized in this time frame. As a result of this the Company made the decision to liquidate certain inventory in order to improve the efficiency of the new fulfillment center as well as to enhance the customer experience. The net effect to the statement of operations of removing this inventory from our site was approximately $1.5 million. In addition, during this transition period the Company experienced some processing issues with a small percentage of orders and returns resulting in a decrease in revenue from repeat business. We believe that these issues had a negative impact on those customers affected at least in the short term. In the long term, we expect the transition to the new Distribution center to improve customer service and increase efficiencies, however, there can be no assurance that the transition will not continue to have a negative impact upon our business, financial condition and results of operations.

Our Ability To Maintain And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan. We are required to pay interest under our loan facility on a monthly basis. Assuming we meet our business plan, we will be able to pay our interest as required. To a certain extent, however, our ability to meet our business plan, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control, and therefore we cannot assure you that based on our business plan we will generate sufficient cash flow from operations to enable us to pay our indebtedness under the loan facility and maintain our minimum availability requirement throughout the term of the agreement. If we fall short of our business plan and are unable to raise additional capital, we could default under our loan facility. In the event of a default under the loan facility, our lender would be entitled, among other things, to foreclose on our assets (whether inside or outside a bankruptcy proceeding) in order to satisfy our obligations under the loan facility. See "Risk Factors - Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility."

If We Are Not Accurate In Forecasting Our Revenues, We May Be Unable To Adjust Our Operating Plans In A Timely Manner. Because our business has not yet reached a mature stage, it is difficult for us to forecast our revenues accurately. We base our current and future expense levels and operating plans on expected revenues, but in the short-term a significant portion of our expenses are fixed. Accordingly, we may be unable to adjust our spending in a timely manner to compensate for any unexpected revenue shortfall. This inability could cause our operating results in some future quarter to fall below the expectations of securities analysts and investors. In that event, the trading price of our Common Stock could decline significantly. In addition, any such unexpected revenue shortfall could significantly affect our short-term cash flow and our net worth, which could require us to seek additional financing and/or cause a default under our loan facility. See "Risk Factors - Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan."

Our National Advertising Campaign and Other Marketing Initiatives May Not Be Successful. Our success depends on our ability to attract customers on cost-effective terms. We have relationships with online services, search engines, and other Web sites and e-commerce businesses to provide other links that direct customers to our Web site. In addition, during 2005 we launched our first national television and advertising campaign, and we have continued and expanded on that campaign since that time. Such campaigns are expensive and may not result in the cost effective acquisition of customers. We are relying on the campaign as a significant source of traffic to our Web site and new customers. If these campaigns and initiatives are not successful, our results of operations will be adversely affected.

We Purchase a Substantial Portion of Our Inventory from One Supplier. In 2007 and 2006, we purchased approximately 38% and 28%, respectively, of our inventory from one supplier. Should our relationship with this supplier deteriorate or terminate, or should this supplier lose some or all of its access to the products that we purchase from it, our performance could

be adversely affected. Under such circumstances, we would be required to seek alternative sources of supply for these products, and there can be no assurance that we would be able to obtain such products from alternative sources on the same terms, or at all. A failure to obtain such products on as favorable terms could have an adverse effect on our revenue and/or gross margin.

We Do Not Have Long Term Contracts With Our Vendors And Therefore The Availability Of Merchandise Is At Risk. We do not have any agreements controlling the long-term availability of merchandise or the continuation of particular pricing practices. Our contracts with suppliers typically do not restrict such suppliers from selling products to other buyers. There can be no assurance that our current suppliers will continue to sell products to us on current terms or that we will be able to establish new or otherwise extend current supply relationships to ensure product acquisitions in a timely and efficient manner and on acceptable commercial terms. In addition, in order to entice new vendors to open up relationships with us, we sometimes are required to either make prepayments or agree to shortened payment terms. Our ability to develop and maintain relationships with reputable suppliers and obtain high quality merchandise is critical to our success. If we are unable to develop and maintain relationships with suppliers that would allow us to obtain a sufficient amount and variety of quality merchandise on acceptable commercial terms, our ability to satisfy our customers' needs, and therefore our long-term growth prospects, would be materially adversely affected. See "Risk Factors - Brand Owners Could Establish Procedures to Limit Our Ability to Purchase Products Indirectly" and "Risk Factors - We Purchase a Substantial Portion of Our Inventory from One Supplier."

The Implementation Of The New Web Site May Place A Significant Strain On Our Resources and Could Result in Start-Up Performance Issues. During 2006, we entered into a Master License Agreement with ATG, pursuant to which we will license certain technology from ATG to be used as a platform for future versions of our Web site, and ATG will provide certain support and consulting services in connection therewith. The new version of our Web site is expected to launch in the second half of 2008/early 2009 and will replace the older version. The launch of the new Web site will involve the use of significant internal and external resources. We will need to develop new internal procedures to operate the new Web site and to make the most effective use of the improvements available on the new Web site. As with any new technology, we may experience instability and performance issues upon launch, and such issues could have a material adverse effect on our revenue and, therefore, our results of operations. While we believe that this project is a prudent investment for our future growth prospects, the return on this investment is not certain and the time and attention required to build out and learn how to best use the new Web site could result in our inability to undertake certain initiatives that could have a more immediate, positive impact on our business and/or distract us from other areas of our business that require the time and attention of those involved in the continued development of the new Web site.

We Are Not In Compliance with Certain Nasdaq Listing Requirements. On August 16, 2007, we were notified by The Nasdaq Stock Market, Inc. ("Nasdaq") that we were not in compliance with the continued listing requirements for the Nasdaq Capital Market because shares of our Common Stock had closed at a per share bid price of less than $1.00 for at least 30 trading days. Under Nasdaq rules, we were given a 180-day grace period to regain compliance, which extended to February 11, 2008. On February 13, 2008, we received a Nasdaq Staff Determination Letter indicating that the Company's common stock had not regained compliance with the $1 minimum bid price continued listing requirement set forth in Marketplace Rule 4310(c)(4) during the 180-day extension period provided the Company in August 2007. The Company would have been entitled to an additional 180-day extension period had it met the initial listing criteria of the Nasdaq Capital Market (other than the minimum bid price requirement) as of the expiration of the initial 180-day period. For a majority of the initial 180-day period, the Company met these criteria and therefore expected that it would be granted the additional extension. However, due to the decrease in the price of the Company's common stock over the first few weeks of 2008, it did not meet the public float requirement of Nasdaq's initial listing criteria as of the determination date, and therefore was not granted the additional extension. Accordingly, the Nasdaq Staff determined that the Company's common stock was subject to delisting from

the Nasdaq Capital Market. The Company requested a hearing before a Nasdaq Listing Qualifications Panel to review the Staff Determination, and the delisting action was stayed pending the issuance of a final decision by the Panel.

In advance of the hearing, on March 13, 2008, the Board of Directors approved a 1 for 10 reverse stock split, which will be effective as of April 3, 2008. While the trading price of our common stock cannot be predicted with certainty, as our common stock begins trading following the reverse stock split, it is expected that the price per share will increase to reflect the reverse stock split. For example, as of March 20, 2008, the last closing sale price reported on NASDAQ was $0.49. Assuming that this was the price per share as of the effective time of the reverse stock split, it is expected that the price per share immediately following the effective time would be $4.90, well above the $1 minimum bid price requirement. Although we have not received a formal decision from the Nasdaq Listing Qualifications Panel, we expect that we will be provided with a short grace period to regain compliance with the minimum bid price requirement following the effectiveness of the reverse stock split. In order to regain compliance with the minimum bid price requirement, our common stock would need to close at or above $1 for 10 consecutive business days following the reverse stock split. There can be no assurance that such reverse stock split will cause the Company to regain compliance for the minimum bid price requirement for the required period of time. The failure to maintain listing on the Nasdaq Capital Market could have a material adverse effect on the price and/or liquidity of our Common Stock.

Unexpected Changes In Fashion Trends Could Cause Us To Have Either Excess or Insufficient Inventory. Fashion trends can change rapidly, and our business is sensitive to such changes. There can be no assurance that we will accurately anticipate shifts in fashion trends and adjust our merchandise mix to appeal to changing consumer tastes in a timely manner. If we misjudge the market for our products or are unsuccessful in responding to changes in fashion trends or in market demand, we could experience insufficient or excess inventory levels or higher markdowns, either of which would have a material adverse effect on our business, financial condition and results of operations. See Risk Factor "Our Business Has Been Impacted by Issues Related to Our Transition to a New Third Party Distribution Center" for a discussion of a write off of inventory taken in the fourth quarter of 2007.

We Will Be Subject To Cyclical Variations In The Apparel And E-Commerce Markets. The apparel industry historically has been subject to substantial cyclical variations. Furthermore, Internet usage slows down in the summer months. We and other apparel vendors rely on the expenditure of discretionary income for most, if not all, sales. Economic downturns, whether real or perceived, in economic conditions or prospects could adversely affect consumer spending habits and, therefore, have a material adverse effect on our revenue, cash flow and results of operations. Alternatively, any improvement, whether real or perceived, in economic conditions or prospects could adversely impact our ability to acquire merchandise and, therefore, have a material adverse effect on our business, prospects, financial condition and results of operations, as our supply of merchandise is dependent on the inability of designers and retailers to sell their merchandise in full-price venues. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority Of Our Vendors And Therefore The Availability of Merchandise Is At Risk."

We Purchase Product From Some Indirect Supply Sources, Which Increases Our Risk of Litigation Involving The Sale Of Non-Authentic Or Damaged Goods. We purchase merchandise both directly from brand owners and indirectly from retailers and third party distributors. The purchase of merchandise from parties other than

the brand owners increases the risk that we will mistakenly purchase and sell non-authentic or damaged goods, which could result in potential liability under applicable laws, regulations, agreements and orders. Moreover, any claims by a brand owner, with or without merit, could be time consuming, result in costly litigation, generate bad publicity for us, and have a material adverse impact on our business, prospects, financial condition and results of operations.

Security Breaches To Our Systems And Database Could Cause Interruptions to Our Business And Impact Our Reputation With Customers, And We May Incur Significant Expenses to Protect Against Such Breaches. A fundamental requirement for online commerce and communications is the secure transmission of confidential information over public networks. There can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments will not result in a compromise or breach of the algorithms we use to protect customer transaction and personal data contained in our customer database. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation with customers, thereby affecting our long-term growth prospects. In addition, 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.

Brand Owners Could Establish Procedures To Limit Our Ability To Purchase Products Indirectly. Brand owners have implemented, and are likely to continue to implement, procedures to limit or control off-price retailers' ability to purchase products indirectly. In addition, several brand owners in the U.S. have distinctive legal rights rendering them the only legal importer of their respective brands into the U.S. If we acquire such product indirectly from distributors and other third parties who may not have complied with applicable customs laws and regulations, such goods could be subject to seizure from our inventory by U.S. Customs Service, and the importer may have a civil action for damages against us. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority of Our Vendors And Therefore The Availability Of Merchandise Is At Risk."

Our Growth May Place A Significant Strain On Our Management And Administrative Resources And Cause Disruptions In Our Business. Historically, our growth has placed, and any further growth is likely to continue to place, a significant strain on our management and administrative resources. To be successful, we must continue to implement information management systems and improve our operating, administrative, financial and accounting systems and controls. We will also need to train new employees and maintain close coordination among our executive, accounting, finance, marketing, merchandising, operations and technology functions. Any failure to implement such systems and training, and to maintain such coordination, could affect our ability to plan for, and react quickly to, changes in our business and, accordingly, could cause an adverse impact on our cash flow and results of operations in the periods during which such changes occur. In addition, as our workforce grows, our exposure to potential employment liability issues increases, and we will need to continue to improve our human resources functions in order to protect against such increased exposure. Moreover, our business is

dependent upon our ability to expand our third-party fulfillment operations, customer service operations, technology infrastructure, and inventory levels to accommodate increases in demand, particularly during the peak holiday selling season. Our planned expansion efforts in these areas could cause disruptions in our business. Any failure to expand our third-party fulfillment operations, customer service operations, technology infrastructure or inventory levels at

the pace needed to support customer demand could have a material adverse effect on our cash flow and results of operations during the period in which such failures occur and could have a long-term effect on our reputation with our customers.

We Are Heavily Dependent On Third-Party Relationships, And Failures By A Third Party Could Cause Interruptions To Our Business. We are heavily dependent upon our relationships with our fulfillment operations provider, third party call center and Web hosting provider, delivery companies like DHL, UPS and the United States Postal Service, and credit card processing companies such as Paymentech and Cybersource to service our customers' needs. To the extent that there is a slowdown in mail service or package delivery services, whether as a result of labor difficulties, terrorist activity or otherwise, our cash flow and results of operations would be negatively impacted during such slowdown, and the results of such slowdown could have a long-term negative effect on our reputation with our customers. The failure of our fulfillment operations provider, third party call center, credit card processors or Web hosting provider to properly perform their services for us could cause similar effects. Our business is also generally dependent upon our ability to obtain the services of other persons and entities necessary for the development and maintenance of our business. If we fail to obtain the services of any such person or entities upon which we are dependent on satisfactory terms, or we are unable to replace such relationship, we would have to expend additional resources to develop such capabilities ourselves, which could have a material adverse impact on our short-term cash flow and results of operations and our long-term prospects. See, "Risk Factor - Our Business Has Been Impacted by Issues Related to Our Transition to a New Third Party Distribution Center."

We Are In Competition With Companies Much Larger Than Ourselves. E-commerce generally and, in particular, the online retail apparel and fashion accessories market, is a new, dynamic, high-growth market and is rapidly changing and intensely competitive. Our competition for customers comes from a variety of sources including:

- existing land-based, full price retailers, that are using the Internet to expand their channels of distribution;
- less established online companies;
- internet sites;
- traditional direct marketers; and
- traditional off-price retail stores, which may or may not use the Internet to grow their customer base.

Competition in our industry has intensified, and we expect this trend to continue as the list of our competitors grows. Many of our competitors and potential competitors have longer operating histories, significantly greater resources, greater brand name recognition and more firmly established supply relationships. We believe that the principal competitive factors in our market include:

- brand recognition;
- merchandise selection;
- price;
- convenience;
- customer service;

- order delivery performance; and
- site features.

There can be no assurance that we will be able to compete successfully against competitors and future competitors, and competitive pressures faced by us could force us to increase expenses and/or decrease our prices at some point in the future.

We Need To Further Establish Brand Name Recognition. We believe that further establishing, maintaining and enhancing our brand is a critical aspect of our efforts to attract and expand our online traffic. The number of Internet sites that offer competing services, many of which already have well established brands in online services or the retail apparel industry generally, increases the importance of establishing and maintaining brand name recognition. Promotion of Bluefly.com will depend largely on our success in providing a high quality online experience supported by a high level of customer service,

which cannot be assured. In addition, to attract and retain online users, and to promote and maintain Bluefly.com in response to competitive pressures, we may find it necessary to increase substantially our advertising and marketing expenditures. If we are unable to provide high quality online services or customer support, or otherwise fail to promote and maintain Bluefly.com, or if we incur excessive expenses in an attempt to promote and maintain Bluefly.com, our long-term growth prospects would be materially adversely affected.

There Can Be No Assurance That Our Technology Systems Will Be Able To Handle Increased Traffic; Implementation Of Changes To Web Site. A key element of our strategy is to generate a high volume of traffic on, and use of, Bluefly.com. Accordingly, the satisfactory performance, reliability and availability of Bluefly.com, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain customers, as well as maintain adequate customer service levels. Our revenues will depend on the number of visitors who shop on Bluefly.com and the volume of orders we can handle. Unavailability of our Web site or reduced order fulfillment performance would reduce the volume of goods sold and could also adversely affect consumer perception of our brand name. We may experience periodic system interruptions from time to time. If there is a substantial increase in the volume of traffic on Bluefly.com or the number of orders placed by customers, we will be required to expand and upgrade further our technology, transaction processing systems and network infrastructure. There can be no assurance that we will be able to accurately project the rate or timing of increases, if any, in the use of Bluefly.com or expand and upgrade our systems and infrastructure to accommodate such increases on a timely basis. In order to remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of Bluefly.com, which is particularly challenging given the rapid rate at which new technologies, customer preferences and expectations and industry standards and practices are evolving in the online commerce industry. Accordingly, we redesign and enhance various functions on our Web site on a regular basis, and we may experience instability and performance issues as a result of these changes. See "Risk Factors - The Implementation Of The New Web Site May Place A Significant Strain On Our Key Personnel."

We May Be Subject To Higher Return Rates. We recognize that purchases of apparel and fashion accessories over the Internet may be subject to higher return rates than traditional store bought merchandise. We have established a liberal return policy in order to accommodate our customers and overcome any hesitancy they may have with shopping via the Internet. As a result, our reserve for returns and

credit card chargebacks for fiscal 2007, 2006 and 2005 has been 39.6%, 39.6% and 37.8%, respectively. If return rates are higher than expected, our business, prospects, financial condition, cash flows and results of operations could be materially adversely affected.

Our Success Is Largely Dependent Upon Our Executive Personnel. We believe our success will depend to a significant extent on the efforts and abilities of our executive personnel. In particular, we rely upon their strategic guidance, their relationships and credibility in the vendor and financial communities and their ability to recruit key operating personnel. Our current employment agreements with our Chief Executive Officer, President and Chief Operating Officer and Chief Marketing Officer run through July 2009, January 2011 and September 2008, respectively, however there can be no assurance that any of them will not terminate their employment earlier. The loss of the services of any of our executive officers could have a material adverse effect on our credibility in the vendor communities and our ability to recruit new key operating personnel.

Our Success Is Dependent Upon Our Ability To Attract New Key Personnel. Our operations will also depend to a great extent on our ability to attract new key personnel with relevant experience and retain existing key personnel in the future. The market for qualified personnel is extremely competitive. Our failure to attract additional qualified employees could have a material adverse effect on our prospects for long-term growth.

There Are Inherent Risks Involved In Expanding Our Operations. We may choose to expand our operations by developing new Web sites, promoting new or complementary products or sales formats, expanding the breadth and depth of products and services offered, expanding our market presence through relationships with third parties, adopting non-Internet based channels for distributing our products, or consummating acquisitions or investments. Expansion of our operations in this manner would require significant additional expenses and development, operations and editorial resources and would strain our management, financial and operational resources. For example, we have historically expended significant internal resources in connection with the redesign of our Web site and the implementation of our online strategic alliances. Moreover, in the event that we expand upon our efforts to open brick-and-mortar outlet stores, we will be required to devote significant internal resources and capital to such efforts. There can be no assurance that we would be able to expand our efforts and operations in a cost-effective or timely manner or that any such efforts would increase overall market acceptance. Furthermore, any new business or Web site that is not favorably received by consumer or trade customers could damage our reputation.

We May Be Liable For Infringing The Intellectual Property Rights Of Others. Third parties may assert infringement claims against us. From time to time in the ordinary course of business we have been, and we expect to continue to be, subject to claims alleging infringement of the trademarks and other intellectual property rights of third parties. These claims and any

resulting litigation, if it occurs, could subject us to significant liability for damages. In addition, even if we prevail, litigation could be time-consuming and expensive and could result in the diversion of our time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims.

We May Be Liable For Product Liability Claims. We sell products manufactured by third parties, some of which may be defective. If any product that we sell were to cause physical injury or injury 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 our insurance coverage, it could have a material adverse effect on our cash flow and on our reputation with customers. Unsuccessful claims could result in the expenditure of funds and management time and could have a negative impact on our business.

We Cannot Guarantee The Protection Of Our Intellectual Property. Our intellectual property is critical to our success, and we rely on trademark, copyright, domain names and trade secret protection to protect our proprietary rights. Third parties may infringe or misappropriate our trademarks or other proprietary rights, which could have a material adverse effect on our business, prospects, results of operations or financial condition. While we enter into confidentiality agreements with our employees, consultants and strategic partners and generally control access to and distribution of our proprietary information, the steps we have taken to protect our proprietary rights may not prevent misappropriation. We are pursuing registration of various trademarks, service marks and domain names in the United States and abroad. Effective trademark, copyright and trade secret protection may not be available in every country, and there can be no assurance that the United States or foreign jurisdictions will afford us any protection for our intellectual property. There also can be no assurance that any of our intellectual property rights will not be challenged, invalidated or circumvented. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries is uncertain and still evolving. Moreover, even to the extent that we are successful in defending our rights, we could incur substantial costs in doing so.

Our Business Could Be Harmed By Consumers' Concerns About The Security Of Transactions Over The Internet. Concerns over the security of transactions conducted on the Internet and commercial online services, the increase in identity theft and the privacy of users may also inhibit the growth of the Internet and commercial online services, especially as a means of conducting commercial transactions. Moreover, although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches could have a material adverse effect on our business, prospects, financial condition and results of operations.

We Face Legal Uncertainties Relating To The Internet In General And To Our Industry In Particular And May Become Subject To Costly Government Regulation. We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. However, it is possible that laws and regulations may be adopted that would apply to the Internet and other online services. Furthermore, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on those companies conducting business online. The adoption of any additional laws or regulations may increase our cost of doing business and/or decrease the demand for our products and services and increase our cost of doing business.

The applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. Any such new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and online commerce could also increase our cost of doing business. In addition, if we were alleged to have violated federal, state or foreign, civil or criminal law, we could face material liability and damage to our reputation and, even if we successfully

defend any such claim, we would incur significant costs in connection with such defense.

We Face Uncertainties Relating To Sales And Other Taxes. We are not currently required to pay sales or other similar taxes in respect of shipments of goods into states other than Ohio and New York. However, state taxation laws and regulations may change in the future, and one or more states may seek to impose sales tax collection obligations on out-of-state companies, such as our company, that engage in online commerce. In addition, any new operation in states outside Ohio and New York could subject shipments into such states to state sales taxes under current or future laws. A successful assertion by one or more states or any foreign country that the sale of merchandise by us is subject to sales or other taxes, could subject us to material liabilities and, to the extent that we pass such costs on to our customers, could decrease our sales.

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The Holders Of Our Common Stock May Be Adversely Affected By The Rights Of Holders Of Preferred Stock That May Be Issued In The Future. Our certificate of incorporation and by-laws, as amended, contain certain provisions that may delay, defer or prevent a takeover. Our Board of Directors has the authority to issue up to 15,479,250 additional shares of preferred stock, and to determine the price, rights, preferences and restrictions, including voting rights, of those shares, without any further vote or action by the stockholders. Accordingly, our Board of Directors is empowered, without approval of the holders of Common Stock, to issue preferred stock, for any reason and at any time, with such rates of dividends, redemption provisions, liquidation preferences, voting rights, conversion privileges and other characteristics as it may deem necessary or appropriate. The rights of holders of Common Stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future.

We Rely On The Effectiveness Of Our Internal Controls. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and assess on an on-going basis the design and operating effectiveness of our internal control structure and procedures for financial reporting. Our independent registered public accounting firm will be required to audit the design and operating effectiveness of our internal controls and attest to management's assessment of the design and the effectiveness of our internal controls. The first such audit will be required for our fiscal year ending December 31, 2008. It is possible that, as we prepare for this audit, we could discover certain deficiencies in the design and/or operation of our internal controls that could adversely affect our ability to record, process, summarize and report financial data. We have invested and will continue to invest significant resources in this process. Because an audit of our internal controls has not been required to be reported in the past, we are uncertain as to what impact a conclusion that deficiencies exist in our internal controls over financial reporting would have on the trading price of our Common Stock.

Item 2. Properties

We lease approximately 26,000 square feet of office space in New York City. The property is in good operating condition. The leases expire in 2010 through 2012. Our total lease expense for the current office space during 2007 was approximately $477,000.

Item 3. Legal Proceedings

In June 2007, we received a Civil Investigative Demand (the "Discovery Request") from the Federal Trade Commission (the "FTC") that requested the production of

certain documents and other information regarding the labeling and advertising of apparel containing products that contain fur or faux fur components. The Discovery Request was issued in connection with a petition filed by the Humane Society of the United States with the FTC regarding the labeling and advertising of fur products by a number of national retailers and apparel manufacturers. The Company is cooperating fully with the Discovery Request.

We currently, and from time to time, are involved in litigation incidental to the conduct of our business. However, we are not party to any lawsuit or proceeding which in the opinion of management is likely to have a material adverse effect on us.

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

No matter was submitted to a vote of stockholders of the Company during the fourth quarter of 2007.

PART II

Item 5. Market For Registrant'S Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

The Company's common stock, par value $.01 per share ("Common Stock"), is quoted on The Nasdaq Capital Market. The following table sets forth the high and low sales prices for the Common Stock for the periods indicated, as reported by the Nasdaq Capital Market:

Fiscal 2007	High	Low
First Quarter	$1.38	$0.98
Second Quarter	$1.20	$0.98
Third Quarter	$1.03	$0.85
Fourth Quarter	$0.97	$0.66

Fiscal 2006	High	Low
First Quarter	$1.49	$0.96
Second Quarter	$1.23	$0.68
Third Quarter	$1.20	$0.93
Fourth Quarter	$1.59	$0.79

On March 13, 2008, the Board of Directors approved a one for 10 reverse stock split, which will be effective as of April 3, 2008. While the trading price of our common stock cannot be predicted with certainty, as our common stock begins trading following the reverse stock split, it is expected that the price per share will increase to reflect the reverse stock split. For example, as of March 20, 2008, the last closing sale price reported on NASDAQ was $0.49. Assuming that this was the price per share as of the effective time of the reverse stock split, it is expected that the price per share immediately following the effective time would be $4.90.

Holders

As of March 20, 2008, there were approximately 115 holders of record of the Common Stock. We believe that there were more than 4,800 beneficial holders of the Common Stock as of such date.

Dividends

We have never declared or paid cash dividends on our Common Stock. In addition, the terms of our credit facility prohibit us from paying cash dividends without the consent of our lender. See Note 11 to the Financial Statements. We currently intend to retain any future earnings to finance future growth and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

Equity Compensation Plan Information

The following table sets forth information as of December 31, 2007 with respect to the Company's equity compensation plans which have been approved by its stockholders. The Company has one equity compensation plan that was not approved by its stockholders.

Plan Category	Number of Securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding option warrants and right (b)
Equity compensation plans approved by security holders	10,726,680(1)	$1.
Equity compensation plans not approved by security holders	246,060	1.
Total	10,972,740	$1.

(1) Includes 3,428,777 options to purchase shares of Common Stock, 396,514 shares of Restricted Stock and 7,147,447 Deferred Stock Units.
(2) Calculated based on the exercise price of the 3,428,777 options referred to in Note 1 above.

The following is a summary of the material provisions of the Bluefly, Inc. 2000 Plan Stock Option Plan (the "2000 Plan"), our only equity compensation plan that has not been approved by our stockholders.

Eligibility. Key employees of the Company who are not officers or directors of the Company and its affiliates and consultants to the Company are eligible to be granted options.

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Administration of the 2000 Plan. The Option Plan/Compensation Committee administers the 2000 Plan. The Option Plan/Compensation Committee has the full power and authority, subject to the provisions of the 2000 Plan, to designate participants, grant options and determine the terms of all options. The 2000 Plan provides that no participant may be granted options to purchase more than 1,000,000 shares of Common Stock in a fiscal year. The Option Plan/Compensation Committee is required to make adjustments with respect to options granted under the 2000 Plan in order to prevent dilution or expansion of the rights of any holder. The 2000 Plan requires that the Option Plan/Compensation Committee be

composed of at least two directors.

Amendment. The 2000 Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Board of Directors, but no amendment without the approval of our stockholders shall be made if stockholder approval would be required under any law or rule of any governmental authority, stock exchange or other self-regulatory organization to which we are subject. Neither the amendment, suspension or termination of the 2000 Plan shall, without the consent of the holder of an option under the 2000 Plan, alter or impair any rights or obligations under any option theretofore granted.

Options Issued Under 2000 Plan. The Option Plan/Compensation Committee determines the term and exercise price of each option under the 2000 Plan and the time or times at which such option may be exercised in whole or in part, and the method or methods by which, and the form or forms in which, payment of the exercise price may be paid.

Upon the exercise of an option under the 2000 Plan, the option holder shall pay us the exercise price plus the amount of the required federal and state withholding taxes, if any. The 2000 Plan also allows participants to elect to have shares withheld upon exercise for the payment of withholding taxes.

The unexercised portion of any option granted to a key employee under the 2000 Plan generally will be terminated (i) 30 days after the date on which the optionee's employment is terminated for any reason other than (a) Cause (as defined in the 2000 Plan), (b) retirement or mental or physical disability, or (c) death; (ii) immediately upon the termination of the optionee's employment for Cause; (iii) three months after the date on which the optionee's employment is terminated by reason of retirement or mental or physical disability; or (iv) (A) 12 months after the date on which the optionee's employment is terminated by reason of his death or (B) three months after the date on which the optionee shall die if such death occurs during the three-month period following the termination of the optionee's employment by reason of retirement or mental or physical disability. The Option Plan/Compensation Committee has in the past, and may in the future, extend the period of time during which an optionee may exercise options following the termination of his or her employment.

Under the 2000 Plan, an option generally may not be transferred by the optionee other than by will or by the laws of descent and distribution. During the lifetime of an optionee, an option under the 2000 Plan may be exercised only by the optionee or, in certain instances, by the optionee's guardian or legal representative, if any.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Period	Total Number of Shares Purchased	Average price Paid per Share	Total Numbe of Shares Purchased a Part of Publicly Announced Plans or Programs
October 1, 2007 -- October 31, 2007	1,233,905(1)	$ 0.92	n/a
November 1, 2007 -- November 30, 2007	-	$ -	n/a
December 1, 2007 -- December 31, 2007	149,925(1)	$ 0.90	n/a

Total -- Three months ended December 31, 2007	1,383,830	$ 0.92	n/a

(1) These shares were withheld by the Company to satisfy the tax withholding obligations of certain officers and employees of the Company in connection with the distribution of common stock in respect of deferred stock units held by such officers and employees.

Item 6. Selected Financial Data

The following selected financial data should be read in conjunction with the financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical results are not necessarily indicative of future results. The selected financial data for the years ended December 31, 2004 and 2003 and at December 31, 2005, 2004 and 2003 are derived from our audited financial statements not included in this report. In January 2006, the start of the first quarter of fiscal 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which requires that the costs resulting from all stock-based payment transactions be recognized in the financial statements at their fair values. Results for prior periods have not been restated for SFAS No. 123(R). All data is in thousands, except share data:

			Year Ended Decemb
	2007	2006	2005
Statement of Operations Data:			
Net sales	$91,493	$77,062	$58,811
Cost of sales	58,754	46,153	35,816
Gross profit	32,739	30,909	22,995
Selling and fulfillment expenses	18,898	15,808	12,880
Marketing expenses	16,063	14,196	6,961
General and administrative expenses	13,848	13,001	6,299
Total operating expenses	48,809	43,005	26,140
Operating loss(2)	(16,070)	(12,096)	(3,145)
Interest expense	(260)	(599)	(856)
Interest/other income	501	502	181
Net loss	(15,829)	(12,193)	(3,820)
Basic and diluted loss per share:	$(0.12)	$(0.23)	$(0.54)
Basic and diluted weighted average number of common shares outstanding available to common stockholders(1)	130,911,295	80,170,532	16,153,020

Balance Sheet Data:	As of December 3

	2007	2006	2005
Cash and cash equivalents	$6,730	$20,188	$9,408
Inventories, net	28,492	24,189	16,893
Other current assets	3,589	4,229	3,536
Total assets	45,019	52,430	33,045
Current liabilities	17,922	14,603	11,936
Long term liabilities	60	--	5,244
Shareholders' equity	27,037	37,827	15,865

(1) Weighted average shares increased to approximately 80.2 million in 2006 as a result an equity financing consummated in June 2006 and the conversion of the Company's preferred stock into common stock in connection with such financing.
(2) This amount includes non-cash expense of approximately $6.2 million and $4.5 million in 2007 and 2006, respectively, related to stock-based compensation, recorded in accordance with SFAS 123R.
(3) Includes restricted cash of $1,253.

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Item 7. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

This discussion and analysis of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections of future events. However, our actual results could differ materially from those discussed herein as a result of the risks that we face, including but not limited to those risks stated in "Risk Factors," or faulty assumptions on our part. In addition, the following discussion should be read in conjunction with the audited financial statements and the related notes thereto included elsewhere in this report.

Overview

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home furnishings at discounts of up to 75% off of retail value. We launched our Web site in September 1998

We believe that there is an opportunity to accelerate the growth of our business while continuing to provide our customers with the great values that they have become accustomed to. In an effort to take advantage of this opportunity, we began a national advertising campaign that featured both print and television. Over the past two and a half years, we have increased awareness by targeting general advertising efforts to a more fashion focused consumer. In 2007, we further refined our marketing strategy by aligning ourselves with entertainment properties, such as BravoTV.com and Project Runway.

During the third quarter of 2007, we completed our transition to a new third party distribution center. In connection with this transition, we incurred incremental expenses of approximately $721,000 in costs directly related to the move (including trucking, labor, insurance, etc.). We took additional charges of approximately $550,000 against our inventory during the third quarter of 2007 based on the reconciliation of inventory that we normally perform in connection with each quarter's close. We believe that the charges that were taken were sufficient to cover any loss of inventory resulting from the transition. We have worked with the distribution center to implement necessary changes to their inventory reporting systems as a result of the full physical inventory that was performed in January 2008, following the end of the Holiday sales and returns

cycle. We believe that significant operational issues related to the move have been resolved. Start-up issues associated with the transition to the new distribution center also resulted in certain cancelled orders and other incremental costs such as expedited shipping costs. As a result of the transition, during the period from June 2007 through mid September 2007, a portion of the Company's inventory was not available for sale to our customers and, therefore, our revenue during this period was adversely affected. Because the increased inventory level could adversely affect our flexibility in taking advantage of other buying opportunities that may become available in the near term, and because of our desire to keep our merchandise fresh we decided not to carry some of this inventory into next season, and removed it from our Web site. We believe that by doing so, we will improve the efficiency of the new fulfillment center and enhance the customer experience. We have taken an inventory write-down with respect to this merchandise because it is being removed from our Web site. The net effect to the statement of operations of removing this inventory from our site, was approximately $1.5 million.

In addition, during this transition period, the Company experienced some processing issues with a small percentage of orders and returns. We believe we have taken the appropriate action related to the customers affected by these processing issues. In the long term, we expect the transition to the new distribution center to improve customer service and increase efficiencies, however, there can be no assurance that the transition will not continue to have a negative impact upon our business, financial condition and results of operations.

Our net sales increased nearly 19% to $91,493,000 for the year ended December 31, 2007 from $77,062,000 for the year ended December 31, 2006. On a quarterly basis, our net sales increased by approximately 31%, 29%, 11% and 9%, respectively, as compared to the same periods in 2006. Our gross margin decreased to 35.8% from 40.1% in 2006. Our gross profit increased by nearly 6% to $32,739,000 for the year ended December 31, 2007 from $30,909,000 for the year ended December 31, 2006. The decrease in gross margin was primarily related to (i) a write off of inventory (ii) a change in the merchandise mix (iii) expedited shipping cost incurred in connection with our transition to the new third-party fulfillment center and (iv) the additional reserves against inventory taken as a result of the transition to the new fulfillment center, as described above. Our operating loss increased by over 32%, to $16,070,000 in 2007, from $12,096,000 in 2006. This increase was primarily a result of a write of inventory in the fourth quarter, an increase in stock-based compensation as a result of equity awards granted in the fourth quarter of 2006 (stock based compensation was $6.2 million for the year ended December 31, 2007 versus $4.5 million for the same period last year) as well as costs incurred in connection with our transition to the new fulfillment center, and increased marketing expenses.

Total marketing expenses increased by 13% to $16,063,000 for the full year 2007, from $14,196,000 for the full year 2006. We increased our spending in marketing (excluding staff related costs) by 14% to $14,908,000 for the full year 2007, from

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$13,040,000 for the full year 2006. The primary goal of our marketing campaign is to build upon the awareness created by the initial launch of the campaign in fall 2005, both with new customers as well as with our existing customers. A large portion of the increased marketing expense was a result of the costs associated with our sponsorships with entertainment properties. We believe that this investment in marketing is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead and marketing on a customer's

first order.

Our reserve for returns and credit card chargebacks remained unchanged at 39.6% of gross sales for the years ended December 31, 2007 and 2006 respectively. In general, our merchandise mix has been shifting towards higher end products which tend to drive return rates higher. We continually try to refine our merchandise mix to reduce the return rate. However, we believe that the higher return rates will be more than offset by the higher gross margin dollars and average order sizes. As such, we continually evaluate our merchandise mix in an effort to reduce return rates.

A portion of our inventory includes merchandise that we either purchased with the intention of holding for the appropriate season or were unable to sell through in its entirety in a prior season and have determined to hold for the next selling season, subject to appropriate mark-downs. We evaluate our inventory on a quarterly basis to determine the lower of cost or the fair market value of that inventory based upon age of the inventory, market factors, and historical trends among other factors, and take the appropriate reserves against inventory. In recent years we have increased the amount of inventory purchased on a pack and hold basis in order to take advantage of opportunities in the market.

On January 1, 2006, we adopted SFAS No. 123(R), which requires expensing of stock options. As a result, we recorded total share-based compensation expenses of $6,194,000 for the year ended December 31, 2007 and $4,454,000 for the year ended December 31, 2006. Results for prior periods have not been restated due to the adoption based on the modified prospective approach.

At December 31, 2007, we had an accumulated deficit of $131,826,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site and building our infrastructure, as well as noncash beneficial conversion charges resulting from decreases in the conversion price of our Preferred Stock and the payment of dividends to holders of Preferred Stock. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. Therefore, we may continue to incur substantial operating losses. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

Critical Accounting Policies

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment, the realization of deferred tax assets, and the calculations related to stock-based compensation. Actual amounts could differ significantly from these estimates.

Revenue Recognition

We recognize revenue in accordance with Staff Accounting Bulletin ("SAB") No. 104 "Revenue Recognition". Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes. Revenue is

recognized when all the following criteria are met:

- A customer executes an order.
- The product price and the shipping and handling fee have been determined.
- Credit card authorization has occurred and collection is reasonably assured.
- The product has been shipped and received by the customer.

Shipping and handling billed to customers are classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and Handling Fees and Costs" ("EITF No. 00-10").

Provision for Returns and Doubtful Accounts

We generally permit returns for any reason within 90 days of the sale. Accordingly, we establish a reserve for estimated future returns and bad debt at the time of shipment based primarily on historical data. We perform credit card authorizations and check the verification of our customers prior to shipment of merchandise. However, our future return and bad debt rates could differ from historical patterns, and, to the extent that these rates increase significantly, it could have a material adverse effect on our business, prospects, cash flows, financial condition and results of operations.

Inventory Valuation

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. This valuation requires us to make judgments based on currently available information, about the saleability of such merchandise, the selling price, etc. Based upon this evaluation, we review our inventory levels in order to identify slow-moving merchandise and establish a reserve for such merchandise.

Deferred Tax Valuation Allowance

We recognize deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income or loss in the period that included the enactment date. We have assessed the future taxable income and determined that a 100% deferred tax valuation allowance is deemed necessary. In the event that we were to determine that we would be able to realize our deferred tax assets, an adjustment to the deferred tax valuation allowance would increase income in the period such determination is made.

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-- an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for the manner in which a company should recognize, measure, present and disclose in its financial statements all material uncertain tax positions that the Company has taken or expects to take on a tax return. As of the date of adoption, there were no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months from the date of adoption of FIN 48 or from December 31, 2007. As of December 31, 2007, the only tax jurisdiction to which the Company

is subject is the United States. Open tax years relate to years in which unused net operating losses were generated. Upon the adoption of FIN 48, the Company's open tax years extend back to 1998. In the event that the Company concludes that it is subject to interest and/or penalties arising form uncertain tax positions, the Company will present interest and penalties as a component of income taxes. No amounts of interest or penalties were recognized in the Company's Statement of Operations or Balance Sheet upon adoption of FIN 48 or as of and for the year ended December 31, 2007.

Stock-Based Compensation

As of January 1, 2006, we adopted SFAS No. 123(R) which requires us to measure compensation cost for stock awards at fair value and recognize compensation over the service period for awards expected to vest. Determining the fair value of stock- based awards at the grant date requires considerable judgment, including estimating expected volatility, expected term, risk-free interest rate and expected forfeitures. If factors change and we employ different assumptions, stock-based compensation expense may differ significantly from what we have recorded in the past.

Results Of Operations

The following table sets forth our statement of operations data for the years ended December 31st. All data is in thousands except as indicated below:

	2007	As a % of Net Sales	2006	As a % of Net Sales	200
Net sales	$91,493	100.0%	$77,062	100.0%	$58,811
Cost of sales	58,754	64.2%	46,153	59.9%	35,816
Gross profit	32,739	35.8%	30,909	40.1%	22,995
Marketing expenses	16,063	17.6%	14,196	18.4%	6,961
Selling and fulfillment expenses	18,898	20.7%	15,808	20.5%	12,880
General and administrative expenses	13,848	15.1%	13,001	16.9%	6,299
Total operating expenses	48,809	53.4%	43,005	55.8%	26,140
Operating loss	(16,070)	(17.6)%	(12,096)	(15.7)%	(3,145)
Interest (expense) other income	241	0.3%	(97)	(0.1)%	(675)
Net loss	$(15,829)	(17.3)%	$(12,193)	(15.8)%	$(3,820)

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We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the years ended December 31st, as indicated below:

	2007	2006	2005
Average Order Size (including shipping & handling)	$276.58	$257.64	$220.17
New Customers Added during the Year*	198,884	177,213	148,975

* Based on unique email addresses

In addition, to the financial statement items and metrics listed above, we also report gross sales, which is a non-GAAP financial measure. We define gross sales as the total dollar amount of orders received by customers (including shipping and handling) net of customer credits, but before any reserves are taken for returns or bad debt. We believe that the presentation of gross sales is useful to investors because (a) it provides an alternative measure of the total demand for the products sold by the Company and (b) it provides a basis upon with which to measure the percentage of total demand that is reserved for both returns and bad debt. Management uses the gross sales measure for these same reasons.

For The Year Ended December 31, 2007 Compared To The Year Ended December 31, 2006

Net sales: Gross sales for the year ended December 31, 2007 increased by approximately 19% to $151,435,000 from $127,556,000 for the year ended December 31, 2006. The increase in gross sales was partially offset by lost sales and cancelled orders attributable to start-up issues at our new distribution center. The provision for returns and credit card chargebacks and other credits was approximately 39.6% for 2007 and 2006, resulting in a provision of $59,942,000 for the year ended December 31, 2007 and $50,494,000 for the year ended December 31, 2006.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2007 were $91,493,000. This represents an increase of nearly 19% compared to the year ended December 31, 2006, in which net sales totaled $77,062,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 7% higher than the full year 2006) and an increase in the number of new customers acquired (approximately 12% higher than the full year 2006). Shipping and handling revenue (which is included in net sales) increased by 9% to $4,798,000 for the year ended December 31, 2007, from $4,403,000 for the year ended December 31, 2006. Revenue from shipping and handling increased at a lower rate than overall revenue due to shipping concessions made during the warehouse move.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the year ended December 31, 2007 totaled $58,754,000, resulting in a gross margin of approximately 35.8%. Cost of sales for the year ended December 31, 2006 totaled $46,153,000, resulting in a gross margin of 40.1%. The decrease in gross margin percentage is largely attributed to a write-off of inventory in the fourth quarter. The effect of this write-off on gross margin dollars was approximately $1.5 million. In addition, the growth in the high-end designer items has a significant impact on the Company's overall merchandise mix, which continues to negatively impact the gross margin percentage. The combination of the high demand amongst retailers for high-end merchandise and the decline in value of the US Dollar relative to the Euro had a negative impact on our gross margins related to designer accessory items.

In addition, the gross margin was negatively affected by additional inventory reserves, and expedited shipping expenses that were recorded during the third quarter and incurred in connection with our transition to a new fulfillment center.

Gross Profit: As a result of the increases in net sales, gross profit increased

by nearly 6%, to $32,739,000 for the year ended December 31, 2007, from $30,909,000 for the year ended December 31, 2006.

Marketing expenses: Marketing expenses increased by 13% to $16,063,000 for the year ended December 31, 2007 from $14,196,000 for the year ended December 31, 2006. This increase was due to an increase in online advertising, offline advertising and sponsorship and direct mail postcards. While overall marketing expenses increased, marketing expenses as a percentage of net sales decreased to 17.5% for the year ended December 31, 2007 from 18.4% for the year ended December 31, 2006. We spent approximately $7.6 million and $7.1 million on our national advertising campaign in 2007 and 2006, respectively.

Marketing expenses include expenses related to our national ad campaign, sponsorships, online and print advertising, "sweepstakes" promotions as well as staff related costs. Costs in connection with the national campaign are recorded as the magazines and commercials are being released.

Selling and fulfillment expenses: Selling and fulfillment expenses increased by approximately 20% for the year ended 2007 compared to the year ended 2006. Selling and fulfillment expenses were comprised of the following:

	Year Ended December 31, 2007	Year Ended December 31, 2006	Percentage Difference increase (decrease)
Operating	10,554,000	8,353,000	26%
Technology	4,693,000	4,203,000	12%
E-Commerce	3,651,000	3,252,000	12%
	$18,898,000	$15,808,000	20%

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in 2007 by 26% compared to 2006 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees), and an increase in customer service and salary related expenses as well as incremental costs of approximately $721,000 incurred in connection with our transition to the new third party distribution center. Variable operating expenses as a percentage of sales decreased in 2007 to approximately 7% from 8% in 2006.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the year ended December 31, 2007, technology expenses increased by approximately 12% compared to the year ended December 31, 2006. This increase was attributed to an increase in staff and related costs, software support, depreciation and training and was partially offset by a decrease in consulting expenses. A majority of the consulting expenses incurred for the year ended December 31, 2007 were related to the continued development of our Web site and capitalized accordingly. As of December 31, 2007, approximately $3,633,000 was capitalized in connection with the continued development of our Web site.

E-Commerce expenses include expenses related to our photo studio, image processing, third party software and Web site design. For the year ended December 31, 2007, this amount increased by approximately 12% as compared to the year ended December 31, 2006. This increase is due to increased expense related to SFAS No. 123R costs, salary related expenses, as well as an increase in expenses associated with software used to support the Web site.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the year ended December 31, 2007 increased to $13,848,000 as compared to $13,001,000 for the year ended December 31, 2006. The increase in general and administrative expenses was primarily the result of a $1,646,000 increase in equity based compensation, $431,000 increase in salary and salary related expense related to additional headcount and increased consulting and professional fees of $302,000. These increases were partially offset by a decrease in bad debt expense of $400,000 related to a receivable due from a third party service provider that purchased inventory from us to be distributed internationally in 2006, public company expenses of $242,000 as well as a decrease in bonuses paid compared to 2006 of $1,016,000.

As a percentage of net sales, general and administrative expenses decreased to 15.1% in 2007 from 16.9% in 2006.

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Loss from operations: Operating loss increased by over 32% in 2007, to $16,070,000 from $12,096,000 in 2006. While net sales increased this year, the increase in net sales was offset by the recording of a write-off of the Company's inventory which resulted in a charge of approximately $1.5 million, additional stock based compensation expense of approximately $1.7 million in accordance with SFAS No.123(R) and the $550,000 inventory charge.

Interest expense and interest, net: Interest and other income for the year ended December 31, 2007 was relatively unchanged compared to December 31, 2006. These amounts relate primarily to interest earned on our cash balances.

Interest expense, is comprised primarily of interest paid on our loan facility and convertible notes which had been held by Soros. For the year ended 2007, interest expense decreased to $260,000 compared to $599,000 for the year ended 2006. The convertible notes were repaid in June 2006, which resulted in the decrease in interest expense for 2007.

Net loss per share: Net loss per share decreased to $0.12 per share from $0.23 per share, as the number of weighted average shares outstanding increased to 130.9 million in 2007 as a result of the equity financing consummated in June 2006 and the conversion of the Company's preferred stock into common stock in connection with such financing.

For The Year Ended December 31, 2006 Compared To The Year Ended December 31, 2005

Net sales: Gross sales for the year ended December 31, 2006 increased by approximately 35% to $127,556,000 from $94,586,000 for the year ended December 31, 2005. The provision for returns and credit card chargebacks and other credits was approximately 40% for 2006 and 38% for 2005, resulting in a provision of $50,494,000 for the year ended December 31, 2006 and $35,775,000 for the year ended December 31, 2005.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2006 were $77,062,000. This represented an increase of over 31% compared to the year ended December 31, 2005, in which net sales totaled $58,811,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 17% higher than the full year 2005) and an increase in the number of new customers acquired (approximately 19% higher

than the full year 2005). Shipping and handling revenue (which is included in net sales) increased by 14% to $4,403,000 for the year ended December 31, 2006, from $3,874,000 for the year ended December 31, 2005. Revenue from shipping and handling increased at a lower rate than overall revenue, due to the increase in our average order size.

Cost of sales: Cost of sales for the year ended December 31, 2006 totaled $46,153,000, resulting in a gross margin of approximately 40.1%. Cost of sales for the year ended December 31, 2005 totaled $35,816,000, resulting in a gross margin of 39.1%. The increase in gross margin was driven by our focus on negotiating better prices with vendors as well as our strategy of selling more in-season product, which has more value to our customer and therefore demands higher margins, and the timing of our promotions.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by over 34%, to $30,909,000 for the year ended December 31, 2006, from $22,995,000 for the year ended December 31, 2005.

Marketing expenses: Marketing expenses increased by 104% to $14,196,000 for the year ended December 31, 2006 from $6,961,000 for the year ended December 31, 2005.

As a percentage of net sales, our marketing expenses increased to 18.4% for the year ended December 31, 2006 from 11.8% for the year ended December 31, 2005. The increase in marketing expenses as a percentage of net sales resulted primarily from costs associated with our national advertising campaign (which was launched in September 2005).

Marketing expenses increased by a higher percentage than revenue as a result of the costs associated with our national marketing campaign.

Selling and fulfillment expenses: Selling and fulfillment expenses increased by approximately 23% for the year 2006 compared to the year ended 2005. Selling and fulfillment expenses were comprised of the following:

	Year Ended December 31, 2006	Year Ended December 31, 2005	Percentage Difference increase (decrease)
Operating	8,353,000	6,925,000	21%
Technology	4,203,000	3,567,000	18%
E-Commerce	3,252,000	2,388,000	36%
	$15,808,000	$ 12,880,000	23%

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Operating expenses increased in 2006 by 21% compared to 2005 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees), and an increase in customer service and salary related expenses. Operating costs as a percentage of sales decreased as a result of economies of scale. Variable expenses related to picking and packing orders increased by 24% to $2.1 million from $1.7 million. Credit card fees during 2006 and 2005 remained relatively unchanged at $1.8 million, as the fees incurred in 2006 were partially offset by a refund of approximately $274,000 from one of our credit card processors. Both expenses remained relatively constant as a percentage of gross sales at 2% for 2006 and

2005.

For the year ended December 31, 2006, technology expenses increased by approximately 18% compared to the year ended December 31, 2005. This increase resulted from an increase in headcount and salary related expenses, consulting expenses and costs associated with software support and was partially offset by a decrease in depreciation expense and a decrease in web hosting expense.

For the year ended December 31, 2006, this amount increased by approximately 36% as compared to the year ended December 31, 2005, primarily due to an increase in salary related expenses as well as increased expenses related to photo shoots. These amounts were partially offset by a decrease in expenses associated with analytic tools.

General and administrative expenses: General and administrative expenses for the year ended December 31, 2006 increased to $13,001,000 as compared to $6,299,000 for the year ended December 31, 2005. The increase in general and administrative expenses was primarily the result of the recording of $3,895,000 of expense related to restricted stock, restricted stock units and employee stock options, an increase of $379,000 in bad debt expense related to a receivable due from a third party service provider that purchased inventory from us to be distributed internationally, increased consulting and professional fees of $392,000, increased public company expenses of $301,000 and increased depreciation expense of $278,000. In June 2006, we paid approximately $650,000 of executive bonuses in connection with the financing that closed during the second quarter of 2006. Most of these bonuses were included in general and administrative expenses. In addition, in November 2006, in connection with their new employment agreements, the company paid bonuses in the aggregate amount of $517,890 to the CEO and CFO intended to compensate them for the income taxes payable on restricted stock awards, received in exchange for their forfeiting their right to certain fully vested and out-of-the-money stock options that would have been exercisable.

As a percentage of net sales, general and administrative expenses increased to 16.9% in 2006 from 10.7% in 2005.

Loss from operations: Operating loss increased by over 284% in 2006, to $12,096,000 from $3,145,000 in 2005.

Interest expense and interest and other income, net: Interest and other income for the year ended December 31, 2006 increased to $502,000 from $181,000 for the year ended December 31, 2005. Interest and other income was higher in 2006, compared to 2005 primarily due to an increase in interest income earned on our cash balances.

For the year ended 2006, interest expense decreased to $599,000 compared to $856,000 for the year ended 2005. The convertible notes were repaid in June 2006, which resulted in the decrease in interest expense for 2006 compared to 2005.

Liquidity And Capital Resources

General

At December 31, 2007, we had approximately $6.7 million in the form of cash and cash equivalents, as compared to $20.2 million at December 31, 2006 and $9.4 million at December 31, 2005. Working capital at December 31, 2007, 2006 and 2005 was $20.9 million, $34.0 million and $17.9 million, respectively. In addition, as of December 31, 2007, we had approximately $3.7 million committed under the Credit Facility, leaving approximately $3.8 million of availability, compared to availability of $4.3 million and $3.75 million at December 31, 2006 and 2005, respectively.

In March 2008, we entered into an agreement with Soros and Maverick pursuant to which they agreed to provide up to $3 million of debt financing to us, on a standby basis, during the next year, provided that the commitment amount will be reduced by the gross proceeds of any equity financing consummated during the year. We can draw down debt in one or more tranches, provided that our cash balances are less than $1 million at the time of any draw down. The draw downs will be evidenced by subordinated

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convertible notes (the "Subordinated Notes") that have a term expiring on the later of June 26, 2011 and three years from the date of the issuance of the Subordinated Notes and bear interest at the rate of 8% per annum, compounded annually. Interest is payable upon maturity or conversion. The Subordinated Notes are convertible (subject to stockholder approval to the extent required by the NASDAQ Capital Market), at the holder's option (a) into equity securities that the Company might issue in any subsequent round of financing at a price that was equal to the lowest price per share paid by any investor in such subsequent round of financing or (b) into Common Stock at a price per share equal to the market price (as defined in the Subordinated Notes) on the date of issuance of the note. In connection with the Commitment, we issued warrants to Soros and Maverick to purchase an aggregate of 525,002 shares of Common Stock at an exercise price equal to the trailing 20-day average stock price on the date of grant.

We fund our operations through cash on hand, operating cash flow and the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance with respect to these financial measures would have a negative impact on our liquidity. Total availability under our Credit Facility with Wells Fargo is based primarily upon our inventory levels. In addition, both availability under the Credit Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Wells Fargo to provide credit support under the Credit Facility. In some instances, new vendors may require prepayments. We may make prepayments in order to open up these new relationships, or to gain access to inventory that would not otherwise be available to us. In addition, we sometimes make prepayments in connection with our advertising campaign, as in some circumstances we need to pay in advance of production. As of December 31, 2007, we had approximately $294,000 of prepaid inventory and $483,000 of prepaid advertising on our balance sheet, as compared to $616,000 and $102,000 as of December 31, 2006 and $485,000 and $677,000 as of December 31, 2005.

Our inventory levels as of December 31, 2007 were approximately $4.3 million higher than at December 31, 2006. The increase in inventory generally reflects a ramp up in connection with our sales growth but also is a result of some of our inventory not being available for sale during our move to our new third party fulfillment center. As a result we expect to carry some of this inventory into next season. However, the increased inventory level could adversely affect our flexibility in taking advantage of other buying opportunities that may become available in the near term.

We believe that our current funds, together with working capital, and operating cash flow, and availability under our existing credit facility and standby commitment from Soros and Maverick will be sufficient to enable us to meet our planned expenditures through at least the next twelve months.

Credit Facility

In July 2005, we entered into a new three year revolving Credit Facility with Wells Fargo. Pursuant to the Credit Facility, Wells Fargo provides us with a revolving loan and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of our assets. Historically, the Credit Facility had also been secured by a letter of credit issued by Soros ("the Soros LC"). In August 2006, Wells Fargo agreed to release the Soros LC, and that it would no longer require an availability reserve (although it has the right under the Credit Facility to establish reserves in the future, as it deems appropriate), so long as we maintain a minimum cash balance of $5,000,000. Furthermore, our Credit Facility prohibits us from paying cash dividends without the consent of our lender. See Note 11 to the Financial Statements.

Availability under the Credit Facility is determined by a formula that considers a certain percentage of our inventory and a certain percentage of accounts receivable. The maximum availability is currently $7,500,000, but can be increased to $12,500,000 at our request, subject to certain conditions. As of December 31, 2007, total availability under the Credit Facility was approximately $7,500,000 of which $3,700,000 was committed, leaving approximately $3,800,000 available for further borrowings.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75% for average excess availability less than $3.0 million and the prime rate plus 0.50% or LIBOR plus 2.50% for average excess availability greater than $3.0 million. We also pay a monthly commitment fee on the unused portion of the facility (i.e., $7,500,000 less the amount of loans outstanding) equal to 0.35%. We also pay Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain specified percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open. Subsequent to year end, we amended the agreement with Wells Fargo, see "Recent Developments" for a full description of the amendment.

Commitments and Long Term Obligations

As of December 31, 2007, we had the following commitments and long term obligations:

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Marketing and Advertising	2,172,000	2,172,000	--	--	--
Purchase Orders	17,155,000	17,155,00	--	--	--
Operating Leases	936,000	449,000	487,000	--	--
Employment Contracts	2,090,000	1,440,000	650,000	--	--
Grand total	$22,353,000	$21,216,000	$1,137,000	--	--

We believe that in order to grow our business, we will need to make additional marketing and advertising commitments in the future. In addition, we expect to hire and train additional employees for the operations and development of Bluefly.com. However, our marketing budget and our ability to hire such employees is subject to a number of factors, including our results of operations as well as the amount of additional capital that we raise.

Off Balance Sheet Arrangements

Certain warrants issued in conjunction with certain preferred stock financing transactions are equity linked derivatives and accordingly represent an off balance sheet arrangement. Each of these warrants meet the scope exception in paragraph 11(a) of FAS 133 and are accordingly not accounted for as derivatives for purposes of FAS 133, but instead included as a component of equity. See Note 8 to the financial statements and the Statement of Shareholders' Equity for more information.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" ("SFAS 141R"), which requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The provisions of SFAS 141R will only impact us if we are party to a business combination after the pronouncement has been adopted.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines the fair value, establishes a framework for measuring fair value and expands disclosure about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Relative to SFAS No. 157, FASB Staff Position (FSP) 157-b delays the effective date of SFAS No. 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. We are evaluating the impact that this statement will have on our financial statements.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-- an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for the manner in which a company should recognize, measure, present and disclose in its financial statements all material uncertain tax positions that the Company has taken or expects to take on a tax return. As of the date of adoption, there were no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months from the date of adoption of FIN 48 or from December 31, 2007. As of December 31, 2007, the only tax jurisdiction to which the Company is subject is the United States. Open tax years relate to years in which unused net operating losses were generated. Upon the adoption of FIN 48, the Company's open tax years extend back to 1998. In the event that the Company concludes that it is subject to interest and/or penalties arising form uncertain tax positions, the Company will present interest and penalties as a component of income taxes. No amounts of interest or penalties were recognized in the Company's Statement of Operations or Balance Sheet upon adoption of FIN 48 or as of and for the year ended December 31, 2007.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We have assessed our vulnerability to certain market risks, including interest

rate risk associated with financial instruments included in cash and cash equivalents. Due to the short-term nature of these investments we have determined that the risks associated with interest rate fluctuations related to these financial instruments do not pose a material risk to us.

Item 8. Financial Statements and Supplementary Data

The financial statements and supplementary data required by this item are included in Part IV, Item 15 of this Form 10-K and are presented beginning on page F-1.

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

None.

Item 9A(T). Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-K, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer along with our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based upon that evaluation, our Chief Executive Officer along with our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and such information is accumulated and communicated to our management, as appropriate, to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

Management's Report on Internal Control Over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a - 15(f) and 15d - 15(f) under the Securities Exchange Act of 1934, as amended. Our management has assessed the effectiveness of our internal control over financial reporting based on the criteria set forth in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on its assessment under the criteria set forth in Internal Control - Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2007. This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the

Company's internal control over financial reporting.

Item 9B. Other Information

In March 2008, we entered into an agreement with Soros and Maverick pursuant to which they agreed to provide up to $3 million of debt financing to us, on a standby basis, during the next year, provided that the commitment amount will be reduced by the gross proceeds of any equity financing consummated during the year. We can draw down debt in one or more tranches, provided that our cash balances are less than $1 million at the time of any draw down. The draw downs will be evidenced by subordinated convertible notes that have a term expiring on the later of June 26, 2011 and three years from the date of the issuance of the Subordinated Notes and bear interest at the rate of 8% per annum, compounded annually. Interest is payable upon maturity or conversion. The Subordinated Notes are convertible (subject to stockholder approval to the extent required by the NASDAQ Capital Market), at the holder's option (a) into equity securities that the Company might issue in any subsequent round of financing at a price that was equal to the lowest price per share paid by any investor in such subsequent round of financing or (b) into Common Stock at a price per share equal to the market price (as defined in the Subordinated Notes) on the date of issuance of the note. In connection with the Commitment, we issued warrants to Soros and Maverick to purchase an aggregate of 525,002 shares of Common Stock at an exercise price equal to the trailing 20-day average stock price on the date of grant.

In March 2008, the Company amended its Credit Facility with Wells Fargo to, among other things, (i) extend the term until July 26, 2011; (ii) change the rate at which interest accrues on the average daily amount under the Credit Facility during the preceding month to a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 3.25% on average excess availability less than $3.0 million and prime rate plus 0.50% or LIBOR plus 3% on average excess availability greater than $3.0 million; (iii) increase the monthly commitment fee on the unused portion of the Credit Facility to 0.50% from 0.35%; (iv) include a servicing fee of $3,333.33 per month; (v) increase the early termination fee to 1% of the revolving credit ceiling, from 0.50% through maturity; and (vi) amend the standby and documentary letter of credit fees to 3.25% and 2.75%, respectively on average excess availability less than $3.0 million, and 3.00% and 2.50%, respectively on average excess availability greater than $3.0 million.

In March 2008, the Company awarded a $200,000 bonus to Melissa Payner-Gregor, its Cheif Executive Officer. The bonus is payable in nine equal monthly installments commencing April 2008, subject to her continued employment by the Company.

Part III

Item 10. Directors and Executive Officers and Corporate Governance

The information required by this Item is incorporated by reference to the Company's definitive proxy statement for the 2008 annual meeting of stockholders.

Item 11. Executive Compensation

The information required by this Item is incorporated by reference to the Company's definitive proxy statement for the 2008 annual meeting of stockholders.

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

The information required by this Item is incorporated by reference to the Company's definitive proxy statement for the 2008 annual meeting of stockholders.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information required by this Item is incorporated by reference to the Company's definitive proxy statement for the 2008 annual meeting of stockholders.

Item 14. Principal Accountant Fees and Services

The information required by this Item is incorporated by reference to the Company's definitive proxy statement for the 2008 annual meeting of stockholders.

Item 15. Exhibits and Financial Statement Schedules

(a) 1. Financial Statements:

Report of Independent Registered Public Accounting Firm
Balance Sheets as of December 31, 2007 and 2006
Statements of Operations for the three years ended December 31, 2007, 2006 and 2005
Statements of Changes in Shareholders' Equity for the three years ended December 31, 2007, 2006 and 2005
Statements of Cash Flows for the three years ended December 31, 2007, 2006 and 2005
Notes to Financial Statements

2. Financial Statement Schedules:

Schedule II - Valuation and Qualifying Accounts

3. Exhibits:

Exhibit No.	Description
3.1	Certificate of Incorporation of the Company (incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2000).
3.2	By-Laws of the Company.
3.3	Amendment to Bylaws of the Company.
3.4	Certificate of Powers, Designations, Preferences and rights of Series F Preferred Stock of the Company (incorporated by reference to the Company' Current Report on Form 8-K, dated June 28, 2005.

10.1	Amended and Restated 1997 Stock Option Plan (incorporated by reference to the Company's Definitive Proxy Statement on Schedule 14A, filed with the Commission on June 29, 2004).
10.2	Lease Agreement by and between the Company and John R. Perlman, et al., dated as of May 5, 1997 (incorporated by reference to the Company's Quarterly Report on Form 10-QSB for the quarterly period ended March 31, 1997).
10.3	Lease Agreement by and between the Company and Adams & Co. Real Estate, Inc., dated March 22, 1999 (incorporated by reference to the Company's Quarterly Report on Form 10-QSB for the quarterly period ended June 30, 1999).
10.4	Lease Agreement by and between the Company and Adams & Co. Real Estate, Inc., dated May 4, 2000 (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2000).
10.5	Bluefly, Inc. 2000 Stock Option Plan (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2000).
10.6	Investment Agreement, dated November 13, 2000, by and among the Company, Bluefly Merger Sub, Inc., Quantum Industrial Partners LDC and SFM Domestic Investments LLC (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000).
*10.7	Software License and Services Agreement, dated March 12, 2002, by and among the Company and Blue Martini Software, Inc. (incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2001).
10.8	Common Stock and Warrant Purchase Agreement, dated May 24, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2002).
10.9	Note and Warrant Purchase Agreement, dated January 28, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto (incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2002).
10.10	Common Stock and Warrant Purchase Agreement dated January 9, 2004 by and among the Company and the Investors listed on Schedule 1 thereto (incorporated by reference to the Company's Current Report on Form 8-K, dated January 13, 2004).

*10.11	Master Service Agreement, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated March 4, 2005).
*10.12	Customer Order Addendum, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated March 4, 2005).

10.13	Preferred Stock and Warrant Purchase Agreement, dated as of June 24, 2005, by and among the Company and the Investors listed on the signature page thereto (incorporated by reference to the Company's Current Report on Form 8-K, dated June 28, 2005).
10.14	Loan and Security Agreement, dated July 26, 2005, by and between the Company and Wells Fargo Retail Finance, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated July 29, 2005).
10.15	Employment Agreement, dated as of September 19, 2005, by and between the Company and Bradford Matson (incorporated by reference to the Company's Current Report on Form 8-K, dated September 22, 2005).
10.16	Stock Purchase Agreement, dated as of June 5, 2006, by and among Bluefly, Inc., Quantum Industrial Partners LDC, SFM Domestic Investments, LLC and the investors listed on the signature pages attached thereto (incorporated by reference to the Company's Current Report on Form 8-K, dated June 7, 2006).
10.17	Form of Voting Agreement by and among Bluefly, Inc., Quantum Industrial Partners LDC, SFM Domestic Investments, LLC, Maverick Fund USA, Ltd., Maverick Fund, L.D.C., Maverick Fund II, Ltd. And Prentice-Bluefly, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated June 7, 2006).
10.18	Fee Letter, dated June 5, 2006, by and among Bluefly, Inc., Quantum Industrial Partners LDC and SFM Domestic Investments, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated June 7, 2006).
10.19	Waiver Letter, dated June 5, 2006, by and between Bluefly, Inc. and Wells Fargo Retail Finance, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated June 7, 2006).
10.20	First Amendment to Loan and Security Agreement, dated as of August 14, 2006, by and between the Company and Wells Fargo Retail Finance, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated August 14, 2006).
10.21	Master License Agreement, dated as of September 28, 2006, by and between the Company and Art Technology Group, Inc. (incorporated by reference to the Company's Current Report on Form 8-K, dated October 3, 2006).
10.22	Bluefly, Inc. Amended and Restated 2005 Stock Incentive Plan (incorporated by reference to the Company's Definitive Proxy Statement on Schedule 14A, filed with the Commission on April 16, 2007).
10.23	Employment Agreement, dated as of November 14, 2006 by and between Bluefly, Inc. and Melissa Payner-Gregor (incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2007).
*10.24	Fulfillment Services Agreement, dated as of April 11, 2007, by and between the Company and Fulfillment Technologies, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated April 17, 2006).

10.25	Service Agreement, dated as of May 9, 2007, by and between the Company and VIPdesk Connect, Inc. (incorporated by reference to the Company's Current Report on Form 8-K, dated May 10, 2007)
*10.26	Letter Agreement, dated as of December 21, 2007, by and between the Company and Fulfillment Technologies, LLC (incorporated by reference to the Company's Current Report on Form 8-K, dated December 27, 2007).

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10.27	Employment Agreement, dated as of January 28, 2008, by and between the Company and Barry Erdos (incorporated by reference to the Company's Current Report on Form 8-K, dated January 28, 2008).
10.28	Employment Agreement, dated as of January 28, 2008, by and between the Company and Patrick Barry (incorporated by reference to the Company's Current Report on Form 8-K, dated January 28, 2008).
10.29	Lease Agreement by and between the Company and 42-52 West 39th Street, LLC, dated February 7, 2008.
10.30	Second Amendment to Loan and Security Agreement, dated as of November 15, 2007, by and between the Company and Wells Fargo Retail Finance, LLC.
10.31	Third Amendment to Loan and Security Agreement, dated as of January 17, 2008 and effective as of January 15, 2008, by and between the Company and Wells Fargo Retail Finance, LLC.
10.32	Amended and Restated Employment Agreement, dated as of March 19, 2008, by and between the Company and Kara B. Jenny (incorporated by reference to the Company's Current Report on Form 8-K, dated March 19, 2008).
10.33	Fourth Amendment to Loan and Security Agreement, dated as of March 26, 2008, by and between the Company and Wells Fargo Retail Finance, LLC.
10.34	Standby Commitment Agreement, dated as of March 26, 2008, by Quantum Industrial Partners LDC, SFM Domestic Investments LLC and private funds associated with Maverick Capital, Ltd. in favor of the Company.
10.35	Warrant No. 1 dated March 26, 2008, issued to Quantum Industrial Partners LDC.
10.36	Warrant No. 2 dated March 26, 2008, issued to SFM Domestic Investments LLC.
10.37	Warrant No. 3 dated March 26, 2008, issued to Maverick Fund USA, Ltd.
10.38	Warrant No. 4 dated March 26, 2008, issued to Maverick Fund LDC.
10.39	Warrant No. 5 dated March 26, 2008, issued to Maverick Fund II, Ltd.
23.1	Consent of PricewaterhouseCoopers LLP.
31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a).

31.2	Certification Pursuant to Rule 13a-14(a)/15d-14(a).
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Confidential treatment has been granted as to certain portions of this Exhibit. Such portions have been redacted.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BLUEFLY, INC.

By: /s/ Melissa Payner-Gregor

Melissa Payner-Gregor
Chief Executive Officer and President

March 27, 2008

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

Signature	Title	Date
/s/ David Wassong David Wassong	Interim Chairman of Board	March 27, 2008
/s/ Melissa Payner-Gregor Melissa Payner-Gregor	Chief Executive Officer (Principal Executive Officer), President and Director	March 27, 2008
/s/ Barry Erdos Barry Erdos	President, and Chief Operating Officer	March 27, 2008
/s/ Kara B. Jenny Kara B. Jenny	Chief Financial Officer (Principal Accounting Officer)	March 27, 2008
/s/ Riad Abrahams Riad Abrahams	Director	March 27, 2008
/s/ Ann Jackson Ann Jackson	Director	March 27, 2008
/s/ Martin Miller	Director	March 27, 2008

Martin Miller

/s/ Neal Moszkowski Neal Moszkowski	Director	March 27, 2008
/s/Christopher McCann Christopher McCann	Director	March 27,2008
/s/ Anthony Plesner Anthony Plesner	Director	March 27, 2008
/s/ Lawrence J. Zigerelli Larry Zigerelli	Director	March 27, 2008

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
of Bluefly, Inc.:

In our opinion, the financial statements listed in the index appearing under Item 15 present fairly, in all material respects, the financial position of Bluefly, Inc. at December 31, 2007 and December 31, 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, the Company changed the manner in which it accounts for uncertain tax positions in 2007 and changed the manner in which it accounts for stock-based compensation in 2006.

/s/ PricewaterhouseCoopers LLP

New York, New York
March 26, 2008

Bluefly, Inc.
Balance Sheets

December 31, 2007 and 2006
(dollars rounded to the nearest thousand)

	2007
Assets	
Current assets	
Cash and cash equivalents	$ 6,730,
Inventories, net	28,492,
Accounts receivable, net of allowance for doubtful accounts	2,102,
Prepaid expenses and other current assets	1,487,
Total current assets	38,811,
Property and equipment, net	6,019,
Other assets	189,
Total assets	$ 45,019,
Liabilities and Shareholders' Equity	
Current liabilities	
Accounts payable	$ 8,460,
Allowance for sales returns	4,204,
Accrued expenses and other current liabilities	2,052,
Deferred revenue	3,206,
Total current liabilities	17,922,
Other long-tern obligations	60,
Total liabilities	17,982,
Commitments and contingencies (Note 7)	
Shareholders' equity	
Series F Preferred Stock - $.01 par value; 7,000 shares authorized, 571.43 issued and outstanding as of December 31, 2007 and 2006, respectively (liquidation preference at December 31, 2007: $571,000 plus $105,000 of accrued dividends, at December 31, 2006: $571,000 plus accrued dividends of $62,000)	
Common Stock - $.01 par value; 200,000,000 and 152,000,000 shares authorized, 134,268,034 and 134,484,854 shares issued and 132,757,301 and 130,484,854 shares outstanding as of December 31, 2007 and 2006, respectively	1,328,
Treasury Stock	(1,430,
Additional paid-in capital	158,965,
Accumulated deficit	(131,826,
Total shareholders' equity	27,037,
Total liabilities and shareholders' equity	$ 45,019,

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

Bluefly, Inc.
Statements of Operations
Years Ended December 31, 2007, 2006 and 2005

(dollars Rounded to the nearest thousand)

	2007	2006	
Net sales	$ 91,493,000	$ 77,062,000	$5
Cost of sales	58,754,000	46,153,000	3
Gross profit	32,739,000	30,909,000	2
Marketing expenses	16,063,000	14,196,000	
Selling and fulfillment expenses	18,898,000	15,808,000	1
General and administrative expenses	13,848,000	13,001,000	
Total operating expenses	48,809,000	43,005,000	2
Operating loss	(16,070,000)	(12,096,000)	(
Interest expense	(260,000)	(599,000)	
Interest income	501,000	502,000	
Net loss	(15,829,000)	(12,193,000)	(
Preferred stock dividends	(44,000)	(2,252,000)	(
Deemed dividend related to beneficial conversion feature on Series F Preferred Stock	-	(3,857,000)	
Net loss available to common shareholders	$(15,873,000)	$(18,302,000)	$(
Basic and diluted loss per common share	$ (0.12)	$ (0.23)	$
Weighted average number of shares outstanding used in calculating basic and diluted loss per common share	130,911,295	80,170,532	1

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

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Bluefly, Inc.
Statements of Changes in Shareholders' Equity
Years Ended December 31, 2007, 2006 and 2005
(dollars rounded to the nearest thousand)

	Preferred Stock $.01 Par Value	
	Number of Shares	Amount
Balance at January 1, 2005	9,358,550	94,000
Sale of Series F Preferred Stock ($1,000 per share net of expenses of $249,000)	7,000	-
Shares Of Series D Preferred Stock Converted into Common Stock	(823)	-

Shares Of Series F Preferred Stock Converted into Common Stock	(1,720)	-
Expense recognized in connection with Issuance of Options	-	-
Exercise of Employee Options	-	-
Net Loss	-	-
Balance at December 31, 2005	9,363,007	94,000
Conversion of Preferred Stock	(9,362,436)	(94,000)
Stock based compensation	-	-
Sale of Common Stock, net of issuance expenses of approximately $2.0 million	-	-
Issuance of Common Stock to Placement Agent	-	-
Warrants Issued to Third-Party	-	-
Dividends Paid to Related Party Shareholders	-	-
Deemed Dividends related to beneficial conversion on Series F Preferred Stock	-	-
Exercise of Employee Options	-	-
Issuance of Restricted Stock	-	-
Net Loss	-	-
Balance at December 31, 2006	571	-
Stock based compensation	-	-
Issuance of Restricted Stock	-	-
Delivery of Restricted Stock Units	-	-
Purchase of Treasury Stock	-	-
Exercise of Employee Options	-	-
Reversal of legal expenses related to June 2006 financing	-	-
Exercise of Related Party Warrant	-	-
Net Loss	-	-
Balance at December 31, 2007	571	-

	Treasury Stock		Additional
	Number of Shares	Amount	Paid-in Capital
Balance at January 1, 2005	-	$ -	$107,270,0
Sale of Series F Preferred Stock ($1,000 per share net of expenses of $249,000)	-	-	6,751,0
Shares Of Series D Preferred Stock Converted into Common Stock	-	-	(15,0
Shares Of Series F Preferred Stock Converted into Common Stock	-	-	(8,0
Expense recognized in connection with Issuance of Options	-	-	41,0
Exercise of Employee Options	-	-	1,488,0
Net Loss	-	-	-
Balance at December 31, 2005	-	$ -	$115,527,0
Conversion of Preferred Stock	-	-	(391,0
Stock based compensation	-	-	4,454,0
Sale of Common Stock, net of issuance expenses of approximately $2.0 million	-	-	47,420,0
Issuance of Common Stock to Placement Agent	-	-	1,070,0
Warrants Issued to Third-Party	-	-	67,0

Dividends Paid to Related Party Shareholders	-	-	(19,512,0
Deemed Dividends related to beneficial conversion on Series F Preferred Stock	-	-	3,857,0
Exercise of Employee Options	-	-	36,0
Issuance of Restricted Stock	-	-	(9,0
Net Loss	-	-	-
Balance at December 31, 2006	-	$ -	$152,519,0
Stock based compensation	-	-	6,194,0
Issuance of Restricted Stock	-	-	(4,0
Delivery of Restricted Stock Units	-	-	(19,0
Purchase of Treasury Stock	1,510,733	(1,430,000)	-
Exercise of Employee Options	-	-	25,0
Reversal of legal expenses related to June 2006 financing	-	-	250,0
Exercise of Related Party Warrant	-	-	-
Net Loss	-	-	-
Balance at December 31, 2007	1,510,733	$(1,430,000)	$158,965,0

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

Bluefly, Inc.
Statements of Cash Flows
Years Ended December 31, 2007, 2006 and 2005

	200
Cash flows from operating activities	
Net loss	$(15,829
Adjustments to reconcile net loss to net cash used in operating activities	
Depreciation and amortization	1,726
Non-cash expense related to warrants issued to supplier	
Provision for returns	(840
Bad debt expense	669
Reserve for inventory obsolesence	2,735
Stock based compensation	6,194
Warrant issued to consultant	
Changes in operating assets and liabilities	
(Increase) decrease in	
Inventories	(7,038
Accounts receivable	(52
Other current assets	(1,293
Prepaid expenses	(114
Other assets	
(Decrease) increase in:	
Accounts payable	3,698
Accrued expenses and other liabilities	1,839
Interest payable to related party shareholders	
Deferred revenue	376
Net cash used in operating activities	(7,929

Cash flows from investing activities	
Cash collateral in connection with Rosenthal Pledge Agreement	
Purchase of property and equipment	(4,110
Net cash used in investing activities	(4,110
Cash flows from financing activities	
Net proceeds from June 2006 financing	
Net proceeds from June 2005 financing	
Purchase of Treasury Stock	(1,430
Net proceeds from exercise of Stock Options	25
Payments of capital lease obligation	(14
Dividends paid to related party shareholders	
Repayment of related party notes	
Net cash provided by financing activities	(1,419
Net increase (decrease) in cash and cash equivalents	(13,458
Cash and cash equivalents	
Beginning of year	20,188
End of year	$ 6,730
Supplemental disclosure of cash flow information	
Cash paid during the year for interest	$ 130
Non-cash investing and financing activites	
Deemed dividend related to beneficial conversion feature on Series F Preferred Stock	$
Issuance of Common Stock to placement agent	$
Conversion of Preferred Stock to Common Stock	$

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

Bluefly, Inc.
Notes to Financial Statements
December 31, 2007

1. The Company

Bluefly, Inc., a Delaware corporation, (the "Company"), is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discount prices. The Company's e-commerce Web site ("Bluefly.com" or "Web site") was launched in September 1998. The Company operates in one business segment that has no operations outside the United States.

The Company has sustained net losses and negative cash flows from operations since the formation of Bluefly.com. The Company's ability to meet its obligations in the ordinary course of business is dependent upon its ability to establish profitable operations or raise additional financing through public or private debt or equity financing, or other sources of financing to fund operations. The Company believes that its

existing resources, together with working capital should be sufficient to satisfy its cash requirements through at least December 31, 2008. The Company may seek additional equity or debt financings to maximize the growth of its business or if anticipated operating results are not achieved. Subsequent to year end, the Company received a commitment for financing in the amount of $3 million from two of its majority shareholders and renewed its Credit Facility. See Note 12 for a complete description.

On August 16, 2007, the Company was notified by The Nasdaq Stock Market, Inc. ("Nasdaq") that it was not in compliance with the continued listing requirements for the Nasdaq Capital Market because shares of its Common Stock had closed at a per share bid price of less than $1.00 for at least 30 trading days. Under Nasdaq rules, the Company was given a 180-day grace period to regain compliance, which extended to February 11, 2008. On February 13, 2008, the Company received a Nasdaq Staff Determination Letter indicating that the Company's common stock had not regained compliance with the $1 minimum bid price continued listing requirement set forth in Marketplace Rule 4310(c)(4) during the 180-day extension period provided the Company in August 2007. The Company would have been entitled to an additional 180-day extension period had it met the initial listing criteria of the Nasdaq Capital Market (other than the minimum bid price requirement) as of the expiration of the initial 180-day period. For a majority of the initial 180-day period, the Company met these criteria and therefore expected that it would be granted the additional extension. However, due to the decrease in the price of the Company's common stock over the first few weeks of 2008, it did not meet the public float requirement of Nasdaq's initial listing criteria as of the determination date, and therefore was not granted the additional extension. Accordingly, the Nasdaq Staff determined that the Company's common stock was subject to delisting from the Nasdaq Capital Market. The Company requested a hearing before a Nasdaq Listing Qualifications Panel to review the Staff Determination, and the delisting action was stayed pending the issuance of a final decision by the Panel.

In advance of the hearing, on March 13, 2008, the Board of Directors approved a 1-for-10 reverse stock split, which will be effective as of April 3, 2008. Subsequently, the Company's common stock price per share will increase to reflect the 1-for-10 reverse stock split.

Although the Company has not received a formal decision from the Nasdaq Listing Qualifications Panel, the Company expects that it will be provided with a short grace period to regain compliance with the minimum bid price requirement following the effectiveness of the reverse stock split. In order to regain compliance with the minimum bid price requirement, the Company's common stock would need to close at or above $1 for 10 consecutive business days following the reverse stock split.

The Company has not retroactively restated its results and accordingly all amounts presented herein are on a pre-split basis.

2. Summary of Significant Accounting Policies

Revenue Recognition

The Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition" ("SAB 104") Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks and adjustments for uncollected sales tax. Revenue is recognized when all the following criteria are met:

- A customer executes an order.
- The product price and the shipping and handling fee have been determined.
- Credit card authorization has occurred and collection is reasonably assured.
- The product has been shipped and received by the customer.

Shipping and handling billed to customers is classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and Handling Fees and Costs" ("EITF No. 00-10").

Provisions for Sales Returns and Doubtful Accounts
The Company generally permits returns for any reason within 90 days of the sale. The Company performs credit card authorizations and checks the verifications of its customers prior to shipment of merchandise. Accordingly, the Company establishes a reserve for estimated future sales returns and allowance for doubtful accounts at the time of shipment based primarily on historical data. Accounts receivable is presented on the consolidated balance sheet net of the allowance for doubtful accounts. As of December 31, 2007 and 2006, the allowance for doubtful accounts was $106,000 and $397,000, respectively, and the allowance for sales returns was $4,204,000 and $5,043,000, respectively.

Deferred revenue, which consists primarily of goods shipped to customers but not yet received and customer credits, totaled approximately $3,206,000 and $2,830,000 as of December 31, 2007 and 2006, respectively.

Cash and Cash Equivalents
The Company considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents.

Inventories
Inventories, which consist of finished goods, are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method. The Company reviews its inventory levels in order to identify slow-moving merchandise and establishes a reserve for such merchandise. Inventory reserves are established based on historical data and management's best estimate of excess inventory. Inventory may be marked down below cost if management determines that the

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inventory stock will not sell at its currently marked price. Inventory is presented net of reserves on the consolidated balance sheet.

As of December 31, 2007 and 2006, inventories, net consists of the following:

	2007	2006
Inventory on hand	$30,146,000	$23,150,000
Inventory to be received due to returns	2,032,000	2,094,000
Inventory reserves	(3,686,000)	(1,055,000)
Total inventories, net	$28,492,000	$24,189,000

Property and Equipment

Property and equipment are stated at cost net of depreciation. Equipment and software are depreciated on a straight-line basis over two to seven years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the lease. Lease amortization is included in depreciation expense. Maintenance and repairs are expensed as incurred.

Certain equipment held under capital leases is classified as property and equipment and amortized using the straight-line method over the lease terms and the related obligations are recorded as liabilities.

Web Site Development Costs

In September 2006, the Company entered into a Master License Agreement (the "Master License Agreement") with a service provider, pursuant to which the Company will license certain technology to be used as a platform for future versions of the Company's Web site. The service provider will provide certain support and consulting services in connection with this project. Beginning in January 2007, the Company began the process of developing an improved version of its Web site based on the new software. In connection with this Master License Agreement, the Company has spent $3,633,000. The entire balance is being capitalized until put into service.

Costs related to the upgrade and development of the Web Site are accounted for in accordance with EITF Issue No. 00-02 "Accounting for Website Development Costs", and to the extent they are capitalized, are amortized over 36 months.

Long-Lived Assets

The Company's policy is to evaluate long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. This evaluation is based on a number of factors, including expectations for operating income and undiscounted cash flows that will result from the use of such assets. The Company has not identified any such impairment of assets.

Income Taxes

The Company recognizes deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income or loss in the period that includes the enactment date. In

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addition, valuation allowances are established when it is more likely than not that deferred tax assets will not be realized.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board ("FASB") -- Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for the manner in which a company should recognize, measure, present and disclose in its financial statements all material uncertain tax positions that the Company has taken or expects to take on a tax return. As of the date of adoption, there were no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months from the date of adoption of FIN 48 or from December 31, 2007. As of December 31, 2007, the only tax jurisdiction to which the Company is subject is the United States. Open tax years relate to years in which unused net operating losses were generated. Upon the adoption of FIN 48, the Company's open tax years extend back to 1998. In the event that the Company concludes that it is subject to interest and/or penalties arising form uncertain tax positions, the Company will present interest and penalties as a component of income taxes. No amounts of interest or penalties were recognized in the Company's Statement of Operations or Balance Sheet upon adoption of FIN 48 or as of and for the year ended December 31, 2007.

Stock-Based Compensation
The Company's Board of Directors has adopted three stock based employee compensation plans, one in April 2005, one in July 2000 and the other in May 1997 (collectively the "Plans"), which are described more fully in Note 8. The Plans, which provide for the granting of restricted stock, deferred stock unit awards and stock options, and other equity and cash awards, were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company, and are similar in nature. Vesting term for restricted stock generally range from one quarter to one year, while deferred stock unit awards vest quarterly over one to three years. Options are granted in terms not to exceed ten years and become exercisable as specified when the option is granted and vesting terms range from immediately to a ratable vesting period of four years. The Plans have an aggregate of 15,700,000 shares authorized for issuance.

Before January 1, 2006, the Company accounted for stock-based compensation under the recognition and measurement principles of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations. The Company did not recognize compensation expense related to stock options granted to employees and directors where the exercise price was at or above fair value at the date of grant. Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As permitted by SFAS No. 123, the Company elected to continue to apply the intrinsic-value-based method of APB No. 25 described above, and adopted only the disclosure requirements of SFAS No. 123, as amended by SFAS No. 148, "Accounting For Stock-Based Compensation - Transition and Disclosure."

On January 1, 2006, the start of the first quarter of fiscal 2006, the Company adopted the provisions of Statement of Financial Accounting

Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which requires that the costs resulting from all share-based payment transactions be recognized in the financial statements at their fair values. The Company adopted SFAS No. 123(R) using the modified prospective application method under which the provisions of

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SFAS No. 123(R) apply to new awards and to awards modified, repurchased, or cancelled after the adoption date. Additionally, compensation cost for the portion of the awards for which the requisite service has not been rendered that are outstanding as of the adoption date is recognized in the Statement of Operations over the remaining service period after the adoption date based on the award's original estimate of fair value. Results for prior periods have not been restated. Total share-based compensation expense recorded in the Statement of Operations for the years ended December 31, 2007 and 2006 was $6,194,000 and $4,454,000, respectively.

On March 29, 2005, the SEC published Staff Accounting Bulletin ("SAB") No. 107, which provides the Staff's views on a variety of matters relating to stock-based payments. SAB No. 107 requires stock-based compensation be classified in the same expense line items as cash compensation. The application of SFAS No. 123(R) had an effect on full year 2006 reported amounts relative to amounts that would have been reported using the intrinsic value method under previous accounting. As a result of adopting SFAS No. 123(R), the Company's operating loss and net loss for the year ended December 31, 2006 was $4,424,000 higher than if it had continued to account for share-based compensation under APB No. 25. Basic and diluted loss per share for the year ended December 31, 2006 would have been $0.06 per share, lower, respectively, if the Company had not adopted SFAS No.123(R). There was no effect on the Company's operating cash flows.

The following table illustrates the effect on net loss and net loss per common share applicable to common stockholders for the year ended December 31, 2005 as if the Company had applied the fair value recognition provisions for stock-based employee compensation of SFAS No. 123(R). For the year ended December 31, 2005 compensation expense of $30,000 was recorded in connection with certain options issued below market value to the Company's Chief Executive Officer in accordance with the terms of her employment agreement. Except for these options, no compensation expense has been recorded for the year ended December 31, 2005 in connection with stock option grants to employees, because the exercise price of employee stock options equals or exceeds the market price of the underlying stock on the date of grant. For purposes of the pro forma presentation, option forfeitures are accounted for as they occurred and no amounts of compensation expense have been capitalized into inventory or other assets, but instead were considered as period expenses (in thousands, except per share data):

December 31, 2007

	Year Ended December 31, 2005
Net loss, as reported	(3,820,000)
Deduct: total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(2,731,000)
Add: Stock-based employee compensation expense included in reported net loss	30,000
Adjusted for Preferred Stock Dividends	(4,958,000)
Pro forma net loss available to common shareholders	(11,479,000)
Loss per share	
Basic and diluted, as reported	($0.54)
Basic and diluted, pro forma	($0.71)

Net Loss Per Share

The Company calculated net loss per share in accordance with SFAS No. 128, "Earnings Per Share." Basic loss per share excludes dilution and is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period. For purposes of calculating basic and diluted loss per share, the Company presents the amount of dividends earned but unpaid on the face of the statement of operations.

Diluted loss per share is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period, adjusted to reflect potentially dilutive securities. Due to the loss, the following shares of Common Stock issuable pursuant to options, warrants, Preferred Stock and Convertible Notes were not included in the computation of diluted earnings per share because the result of such inclusion would be antidilutive:

	Common Stock Issuable			
	2007	2006	2005	Exercise Prices
Security				
Options	3,428,777	5,417,116	8,038,528	$0.80 - $2.73
Restricted Stock Awards	7,543,963(2)	10,723,488(2)	-	n/a
Warrants	1,214,249	1,695,893	1,883,393	$0.78 - $3.96
Preferred stock	758,620(1)	758,620(1)	44,516,119	

(1) At December 31, 2007 and 2006, there were 571 shares of Series F Convertible Preferred Stock outstanding that are convertible into approximately 696,341 shares of Common Stock (excluding dividends).

(2) Includes both Restricted Stock and Restricted Stock Units

As discussed in Note 12 below, in March 2008, the Company announced that

it would effect a reverse stock split (the "Reverse Stock Split"). In connection with the Reverse Stock Split holders of the Company's Common Stock would receive one share of Common Stock for every 10 shares of Common Stock that they held as of April 3, 2008, the record date.

Upon effectiveness of the Reverse Stock Split, the net loss per share on a proforma basis would be as follows:

	2007 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)
net loss per share - as reported	$(0.12)	$(0.23)	$(0.54)
net loss per share - after split	$(1.21)	$(2.28)	$(5.43)

Marketing Expenses
In addition to marketing salaries, marketing expenses consist primarily of online advertising, print and media advertising, costs associated with sweepstakes, direct mail campaigns as well as the related external production costs. In accordance with SOP 93-7 "Reporting on Advertising Costs," the costs associated with online and print advertising are expensed as incurred, with the exception of production costs related to print and television advertising which are expensed entirely the first time the advertising takes place. The costs associated with direct mail campaigns are capitalized and charged to expense over the expected future revenue stream. There were no amounts associated with direct mail campaigns capitalized at December 31, 2007 and 2006. For the year ended December 31, 2007, 2006 and 2005 marketing spend (excluding staff related costs) were, $14.9 million, $13.0 million and $6.7 million, respectively.

Fulfillment Expenses
The Company utilizes a third party to perform all of its order fulfillment including warehousing, administrative support, returns processing and receiving labor. For the years ended December 31, 2007, 2006 and 2005, fulfillment expenses totaled $4,390,000, $4,409,000 and $3,642,000, respectively.

Fair Value of Financial Instruments
The carrying amounts of the Company's financial instruments, including cash and cash equivalents, other assets, accounts payable, and accrued liabilities, approximate fair value due to their short maturities.

Recent Accounting Pronouncements
In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" ("SFAS 141R"), which requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the

business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The provisions of SFAS 141R will only impact the Company if it is party to a business combination after the pronouncement has been adopted.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines the fair value, establishes a framework for measuring fair value and expands disclosure about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Relative to SFAS No. 157, FASB Staff Position (FSP) 157-b delays the effective date of SFAS No. 157 for all non-financial assets and liabilities, except those that are recognized or

disclosed at fair value in the financial statements on a recurring basis. The Company is evaluating the impact that this statement will have on its consolidated financial statements.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for the manner in which a company should recognize, measure, present and disclose in its financial statements all material uncertain tax positions that the Company has taken or expects to take on a tax return. As of the date of adoption, there were no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months from the date of adoption of FIN 48 or from December 31, 2007. As of December 31, 2007, the only tax jurisdiction to which the Company is subject is the United States. Open tax years relate to years in which unused net operating losses were generated. Thus upon adoptions of FIN 48, the Company's open tax years extend back to 1998. In the event that the Company concludes that it is subject to interest and/or penalties arising from uncertain tax positions, the Company will present interest and penalties as a component of income taxes. No amounts of interest or penalties were recognized in the Company's Statement of Operations or Balance Sheet upon adoption of FIN 48 or as of and for the year ended December 31, 2007.

Concentration
The Company acquired approximately 38.3% and 27.5% of its inventory from one supplier for fiscal 2007 and 2006, respectively.

Use of Estimates
The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions include the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment, realization of deferred tax assets, and the calculations related to stock-based

compensation. Actual results could differ from those estimates.

3. Property and Equipment

As of December 31, 2007 and 2006, property and equipment consists of the following:

	2007	2006
Leasehold improvements	$ 1,853,000	$ 1,814,000
Office equipment	627,000	594,000
Computer equipment and software	13,138,000	9,101,000
	15,618,000	11,509,000
Less: Accumulated depreciation	(9,599,000)	(7,936,000)
	$ 6,019,000	$ 3,573,000

Depreciation and amortization of property and equipment was approximately $1,639,000, $1,419,000 and $1,145,000, for the years ended December 31, 2007, 2006 and 2005, respectively.

4. Prepaid Expenses and Other Current Assets

As of December 31, 2007 and 2006, prepaid expenses and other current assets consist of the following:

	2007	2006
Prepaid expenses	$ 777,000	$ 341,000
Prepaid inventory	294,000	616,000
Other current assets	416,000	553,000
	$1,487,000	$1,510,000

5. Accrued Expenses and Other Current Liabilities

As of December 31, 2007 and 2006, accrued expenses and other current liabilities consist of the following:

	2007	2006
Salary, vacation and bonus accrual	$ 802,000	$ 763,000
Accrued media expenses	977,000	667,000
Other accrued expenses	273,000	478,000
	$2,052,000	$1,908,000

6. Income Taxes

Significant components of the Company's deferred tax assets and liabilities as of December 31, are summarized as follows:

	2007	2006
Deferred tax assets		
Net operating losses	$ 34,765,000	$ 33,437,000
Depreciation and amortization	213,000	285,000
Accounts receivable and inventory reserves	374,000	587,000
Other accruals	304,000	313,000
Stock options	2,146,000	(2,201,000)
Returns reserve	1,641,000	2,038,000
	39,443,000	34,459,000
Valuation Allowance	(39,443,000)	(34,459,000)
Net deferred tax asset (liability)	$ -	$ -

The Company is in an accumulated loss position for both financial and income tax reporting purposes. The Company has U.S. Federal net operating loss carryforwards of approximately

$89,043,000 at December 31, 2007 which have expiration dates from 2018 through 2027. Pursuant to Section 382 of the Internal Revenue Code, the usage of these net operating loss carryforwards may be limited due to changes in ownership that have occurred or that may occur in the future. The Company has not yet determined the impact, if any, that changes in ownership have had on net operating loss carryforwards. The Company provided a full valuation allowance on the entire deferred tax asset balance to reflect the uncertainty regarding the realizability of these assets due to operating losses incurred since inception.

The Company's effective tax rate differs from the U.S. Federal Statutory income tax rate of 34% as follows:

	2007	2006	2005
Statutory federal income tax rate	(34.00)%	(35.00)%	(35.00)%
State tax benefit, net of federal taxes	(5.04)%	(5.41)%	(5.41)%
Other	0.93%	2.23%	0.27%
Valuation allowance on deferred tax asset	38.11%	38.18%	40.14%
Effective tax rate	0.00%	0.00%	0.00%

7. Commitments and Contingencies

Employment Contracts

The Company has employment agreements with certain of its executive officers. These employment agreements have terms expiring through July 2009. As of December 31, 2007, the Company's aggregate cash commitment for future base salary under these employment contracts is:

2008	$1,440,000

2009	425,000
2010	225,000
	$2,090,000

Leases

The Company leases space under operating leases that expire at various dates through 2010. Future minimum lease payments under these operating leases, excluding utilities, that have initial or remaining non-cancelable terms in excess of one year are as follows:

	Operating Leases
2008	$449,000
2009	342,000
2010	145,000
Thereafter	-
Total minimum payments	$936,000

Rent expense (including amounts related to commercial rent tax) aggregated approximately $500,000, $566,000 and $450,000 for the years ended December 31, 2007, 2006, and 2005, respectively.

Marketing Commitments

As of December 31, 2007, the Company has advertising and marketing commitments in connection with email services, agency fees and costs in connection with a national ad campaign of approximately $2,172,000 through December 31, 2008.

Legal Proceedings

The Company is, from time to time, involved in litigation incidental to the conduct of its business. However, the Company is not party to any lawsuit or proceeding which, in the opinion of management is likely to have a material adverse effect on its financial condition.

8. Shareholders' Equity

Authorized Shares

The Company is incorporated in Delaware and has 200,000,000 authorized shares of common stock, $.01 par value per share ("Common Stock"), and 25,000,000 authorized shares of preferred stock, $.01 par value per share (the "Preferred Stock"). The Preferred Stock is designated as follows: 500,000 shares of Series A Convertible Preferred Stock (the "Series A Preferred Stock"); 9,000,000 shares of Series B Convertible Preferred Stock (the "Series B Preferred Stock"); 3,500 shares of Series C Convertible Preferred Stock (the "Series C Preferred Stock"); 2,100 shares of Series 2002 Convertible Preferred Stock (the "Series 2002 Convertible Preferred Stock"); 7,150 shares of Series D Convertible Preferred Stock (the "Series D Preferred Stock"); 1,000 shares of Series E Convertible Preferred Stock (the "Series E Preferred Stock"); 7,000

shares of Series F Convertible Preferred Stock (the "Series F Preferred Stock"); and 15,479,250 shares undesignated and available for issuance.

Preferred Stock
Outstanding Shares
The Company's currently has 571.43 shares of Series F Preferred Stock outstanding with a stated value of approximately $571,430. In June 2006, all of the Series A, B, C, D and E shares of Preferred Stock, as well as a significant portion of the Series F Preferred Stock, were converted in to shares of Common Stock, as more fully discussed in the "June 2006 Financing" below.

Dividends
Each share of Series F Preferred Stock bears a cumulative compounding dividend, payable upon conversion in cash or Common Stock, at the Company's option, at the rate of 7% per annum.

Ranking
The Series F Preferred Stock ranks senior to the Common Stock, with respect to the payment of distributions on liquidation, dissolution or winding up of the Company and with respect to the payment of dividends.

Conversion
The Series F Preferred Stock is convertible into Common Stock at the rate of $2.32 in stated value per share of Common Stock.

The Series F Preferred Stock contains anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that the Company issues or sells its Common Stock or new securities convertible into its Common Stock in the future for less than the conversion price of the Series F Preferred Stock, the conversion price of the Series F preferred stock would be decreased to the price at which such Common Stock or other new securities are sold. As more fully described below, the conversion price of the Series F Preferred Stock was reduced from $2.32 per share to $0.82 per share in connection with the June 2006 Financing as a result of these anti-dilution provisions.

Voting Rights
The Series F Preferred Stock votes with the Common Stock on an as-converted basis.

Redemption
The Company is entitled to redeem the shares of Series F Preferred Stock for cash at a price equal to the stated value, plus accrued and unpaid dividends.

June 2006 Financing
On June 15, 2006 (the "Closing Date"), the Company completed a private placement (the "Private Placement") through the sale of 60,975,610 shares of its common stock, par value $0.01 per share (the "Common Stock"), at a price of $0.82 per share. The Private Placement was made to affiliates of Maverick Capital, Ltd. ("Maverick") and Prentice Capital Management, LP ("Prentice"). The aggregate proceeds from the Private Placement were $50 million, almost half of which was purchased by each of Maverick and

Prentice. The purchase price of $0.82 per share represented an 11% premium to the closing bid price of the Common Stock on June 5, 2006, the date of signing of the definitive stock purchase agreement. The shares purchased in the Private Placement included 203,016 shares of Common Stock that were purchased by a holder of Series D Convertible Preferred Stock in connection with the exercise of such holder's preemptive rights. The amount purchased by Maverick and Prentice in the Private Placement was reduced on a pro rata basis as a result of the exercise of such holder's preemptive rights.

Concurrent with the closing of the Private Placement, affiliates of Soros Fund Management LLC ("Soros") converted all of their outstanding Preferred Stock into 44,729,960 shares of the Company's Common Stock. The remaining shares of Series D Convertible Preferred Stock, which were held by investors other than Soros, automatically converted into an aggregate of 1,073,936 shares of Common Stock. The placement agent for the Private Placement was paid a commission of 5% of the gross proceeds, half of which was paid by the Company and the other half by Soros. Of the commission paid by the Company, $1 million was paid through the issuance of Common Stock and the remainder was paid in cash.

On the Closing Date, the Company paid Soros $25 million in cash, which represented $4,000,000 of the principal and $1,488,376 of accrued but unpaid interest on the outstanding convertible notes (the "Notes") held by Soros and the majority of the accrued but unpaid dividends on the shares of Preferred Stock that were converted by Soros in connection with the Private Placement, with the remaining accrued but unpaid dividends on such shares of Preferred Stock paid in shares of Common Stock. The remaining proceeds were used by the Company for general corporate purposes. As a result of the Private Placement and the conversion of the Preferred Stock, Soros collectively owns approximately 39% of the Company's Common Stock, and each of Maverick and Prentice own approximately 24% of the Company's Common Stock.

As a result of the Private Placement, the conversion price of the Company's Series F Convertible Preferred Stock, the majority of which was held by Soros, automatically decreased from $2.32 to $0.82. In accordance with FASB Emerging Issue Task Force Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," this reduction in the conversion price of the Company's Series F Preferred Stock resulted in the Company recording a beneficial conversion feature in the approximate amount of approximately $3.9 million as part of its second quarter financial results. This non-cash charge, which is analogous to a dividend, resulted in an adjustment to the Company's computation of Loss Per Share.

The Company agreed to use its commercially reasonable efforts to (i) prepare and file with the Securities and Exchange Commission (the "Commission") a registration statement (the "Registration Statement") to register the shares of Common Stock sold in the Private Placement within 120 days of the Closing Date and (ii) cause the Registration Statement to be declared effective by the Commission within 180 days of the Closing Date. The Registration Statement has since been filed and declared effective.

In connection with the June 2006 Private Placement, $603,928 of cumulative unpaid dividends was settled through the issuance of 794,642 shares of Common Shares. These shares were computed by using the conversion price of the Series D Preferred Stock ($0.76) as required by the terms of the Private Placement.

In connection with the June 2006 Financing, the Company repaid the Convertible Promissory Notes issued to Soros in July and October 2003 (the "Notes"). The Company paid $4,000,000 of principal and $1,488,376 of interest. The Notes were set to mature in May 2007 and bore interest at 12% per annum.

June 2005 Financing

The Company raised over $7,000,000 in equity financing in June 2005. The financing was effected through a private placement (the "June 2005 Financing") that closed on June 24, 2005. The Company raised $7,075,431 through the sale of 7,000 shares of newly designated Series F Preferred Stock for an aggregate purchase price of $7,000,000 and warrants to purchase an additional 603,448 shares of its common stock at an exercise price of $2.87 per share. The warrants have an expiration date of June 24, 2008. The aggregate purchase price for the warrants was $75,431, or $0.125 per warrant, and all of the warrants were purchased by the New Investors described below. The investors participating in the June 2005 Financing included eight private equity funds that had not previously participated in the Company's financing transactions (the "New Investors"), and two private equity funds affiliated with Soros. In connection with the June 2005 Financing, the New Investors also purchased from Soros previously issued shares of the Company's Series D Preferred Stock with an aggregate liquidation preference and accrued dividends of $3,000,000.

Warrants to Purchase Common Stock

Warrants Issued to Investors

The Company used the Black-Scholes option pricing method (assumption: volatility 79%, risk free rate 3.86% one and a half year expected life and zero dividend yield) to calculate the value of the 603,448 warrants issued in connection with the June 2005 Financing. Using those assumptions a value of approximately $423,000 was assigned to the warrant. In accordance with EITF 00-27, Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" the Company evaluated the total value ascribed to the warrants under Black-Scholes and compared that to the total proceeds raised. In connection with that the Company recognized a beneficial conversion feature of approximately $87,000.

Warrants to Soros

The Company has issued warrants to Soros in connection with past and recent financings as well as in connection with the Company's previous Loan Facility (which has since been refinanced). Warrants issued in connection with the Company's Loan Facility are included in the table below and are described more fully in Note 10.

Warrants Issued to Consultant

In February 2006, the Company issued a warrant to a consultant in exchange for investor relations services. The Company used the Black-Scholes option pricing method (assumption: volatility 118%, risk free rate 4.49%, five years expected life and zero dividend yield) to calculate the value of the 100,000 warrants issued in connection with a warrant issued to a consultant. Using those assumptions a value of approximately $67,000 was assigned to the warrant and charged to general and administrative expenses. These warrants expire in February 2011.

The following table represents warrants issued to purchase Common Stock as of December 31, 2007:

Party	Number of Warrants	Exercise Price Range	Expiration Dates
Investors	989,249	$2.87 - $3.96	June 2008 - January 2009
Soros	125,000	$0.78 - $0.88	September 2011 - March 2013
Consultant	100,000	$1.00	February 2011
	1,214,249		

Stock-Based Compensation Plans

The Company's Board of Directors has adopted three stock based employee compensation plans. The Plans, which provide for the granting of restricted stock, restricted stock units, stock options and other equity and cash awards, were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company.

In November 2006, the Company entered into three year employment contracts with its Chief Executive Officer ("CEO") and then Chief Financial Officer ("CFO"). In connection with these agreements, the CEO and CFO were entitled to, among other things, (i) restricted stock awards under our Plans for a total of 861,221 shares of our Common Stock, (which vested in full on January 1, 2007) plus cash bonuses of $517,890 (intended to compensate them for the income taxes payable on such restricted stock awards) in exchange for the forfeiting of their right to certain fully vested and out-of-the-money stock options that would have been exercisable to purchase an aggregate of 2,518,458 shares of Common Stock; (ii) deferred stock unit awards under the Plan for 172,741 underlying shares of Common Stock (which vest quarterly over a two year period), in exchange for the forfeiting of their right to certain unvested and out-of-the-money stock options that would have been exercisable to purchase an aggregate of 326,454 shares of Common Stock; and (iii) subject to the approval of the Company's stockholders of certain amendments to the Plans, deferred stock unit awards representing 8,264,524 shares of Common Stock with one-third of such deferred stock units vesting quarterly, in equal amounts, over a twelve month period, one-third vesting quarterly, in equal amounts, over a twenty-four month period, and one-third vesting quarterly, in equal amounts, over a thirty-six month period. The vesting period for all awards

commences on October 1, 2006. In May 2007 the Company's stockholders approved these amendments to the Plans.

The Company recorded the exchange of the options for restricted stock and deferred stock unit awards as replacement awards, and therefore under SFAS No. 123R treated the exchange as a modification of the original option grant and recorded incremental compensation cost measured as the excess of the fair value of the replacement awards, measured immediately after modification, over the fair value of the cancelled award, measured immediately before modification, at the modification date. Total incremental compensation expense was approximately $507,000. In connection with these new awards, the Company recognized an expense of $9.3 million over three years. Approximately $4.5 million and $2.1 million of this expense was recognized in 2007 and 2006, respectively.

In connection with these grants described above, the Company has given the employee holders of the shares of Restricted Stock and Restricted Stock Units the ability to settle taxes due upon delivery of the shares on a net share basis. Shares used to satisfy taxes are then charged to Treasury Stock. During 2007, the Company acquired 1,510,733 shares of Treasury Stock.

Restricted Stock and Deferred Stock Unit Awards

The following table is a summary of activity related to restricted stock and deferred stock units grants for key employees at December 31, 2007:

	Restricted Stock	Weighted Average Grant Date Fair Value	Deferred Stock Unit Awards	Weighte Averag Grant Date Fa Value
Balance at January 1, 2006	--		--	
Shares/Units Granted	861,221	$0.95	9,862,267	$0.94
Shares/Units Forfeited	--		--	
Balance at December 31, 2006	861,221	$0.95	9,862,267	$0.94
Shares/Units Granted	426,192	$1.26	544,405	$1.22
Shares/Units Forfeited	(29,678)	$1.27	(29,381)	$1.27
Shares/Units Restriction Lapses	(861,221)	$0.95	(3,229,842)	$0.94
Balance at December 31, 2007	396,514	$1.26	7,147,449	$0.96
Aggregate Grant Date Fair Value	$499,608		$6,861,551	
Vesting Service Period of Shares Granted	1 year		12 - 36 months	
Number of shares/units vested during December 31, 2006	--		--	
Number of shares/units unvested at December 31, 2006	861,221		9,862,267	
Number of shares/units vested during December 31, 2007	861,221		3,229,842	
Number of shares/units unvested at December 31, 2007	396,514		7,147,449	

For the years ended December 31, 2007 and 2006 the Company recognized expense of approximately $5,678,000 and $2,159,000 in connection with these awards.

As of December 31, 2007 the total compensation cost related to non-vested restricted stock and deferred stock units not yet recognized was $3.8 million.

Stock Options
The following table summarizes the Company's stock option activity:

	Number of Shares	Weighted Average Exercise Price
Balance at January 1, 2005	9,813,379	$2.28
Options granted	2,039,000	$1.39
Options canceled	(2,216,567)	$3.56
Options exercised	(1,597,284)	$0.94
Balance at December 31, 2005	8,038,528	$1.97
Options granted	521,000	$0.96
Options canceled	(3,099,082)	$2.32
Options exercised	(43,330)	$0.82
Balance at December 31, 2006	5,417,116	$1.68
Options granted	60,000	$0.97
Options canceled	(2,020,278)	$2.76
Options exercised	(28,061)	$0.89
Balance at December 31, 2007	3,428,777	$1.06
Vested at December 31, 2005	4,969,929	$2.15
Vested at December 31, 2006	3,682,877	$1.83
Vested at December 31, 2007	2,871,126	$1.04

The stock options are exercisable in different periods through 2017. Additional information with respect to the outstanding options as of December 31, 2007, is as follows:

Options Outstanding   Options Exercisabl

Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable	We Av Ex
$0.51 - $1.00	2,006,331	5.5 Years	$0.91	1,842,691	
$1.01 - $1.50	1,373,644	7.4 Years	$1.24	992,177	
$1.51 - $2.00	41,302	4.3 Years	$1.66	27,758	
$2.01 - $2.50	3,750	3.1 Years	$2.16	3,750	
$2.51 - $3.00	3,750	2.9 Years	$2.73	3,750	
$0.51 - $3.00	3,428,777	6.2 Years	$1.06	2,870,126	

The total fair value of the 2,545,143 options that vested during the year was approximately $2,638,000. At December 31, 2007, the aggregate intrinsic value of the fully vested options was $0 and the weighted average remaining contractual life of the options was 5.9 years. The Company has not capitalized any compensation cost, or modified any of its stock option grants for the years ended December 31, 2007 and 2006, except for those described in connection with the Offer to Exchange. Other selected information is as follows:

	2007	2006	2005
Aggregate intrinsic value of outstanding options	$0	$881,000	$399,000
Aggregate intrinsic value of options exercised	$7,000	$7,000	$1,088,000
Weighted average fair value of options granted	$0.97	$0.79	$1.24

As of December 31, 2007, the total compensation cost related to non-vested stock option awards not yet recognized was $520,000. Total compensation cost is expected to be recognized over 1.3 years on a weighted average basis.

The fair value of options granted is estimated on the date of grant using a Black-Scholes option pricing model. Expected volatilities are calculated based on the historical volatility of the Company's stock. Management monitors share option exercise and employee termination patterns to estimate forfeiture rates within the valuation model. The expected holding period of options represents the period of time that options granted are expected to be outstanding. The risk-free interest rate for periods within the expected life of the option is based on the interest rate of U.S. Treasury note in effect on the date of the grant. The Company had previously recorded expense in accordance with APB No. 25 for certain options issued to its President that were issued below market. Prior to the adoption of FAS 123(R), the Company recognized actual forfeitures when they occurred but has not recorded a cumulative effect adjustment to record estimated forfeitures related to these below market options as the balance was immaterial.

The table below presents the assumptions used to calculate the fair value of options granted for the year ended December 31, 2007, 2006 and 2005 respectively:

Notes to Financial Statements
December 31, 2007

	Year Ended December 31,		
	2007	2006	2005
Risk-free interest rates	4.56%	4.65%	4.22%
Expected life (in years)	5.5	6	6
Dividend yield	0%	0%	0%
Expected volatility	94%	101%	138%

In January 2007, the Company commenced an exchange offer pursuant to which it is offering to exchange certain outstanding stock options issued to employees and non-employee directors for restricted stock awards and/or deferred stock unit awards. See Note 9 below.

9. Offer to Exchange

In January 2007, the Company commenced an exchange offer (the "Offer") pursuant to which it offered to exchange certain outstanding stock options issued to employees and non-employee directors for restricted stock awards and/or deferred stock unit awards.

Employees (other than the CEO and CFO, who already had exchanged certain of their options pursuant to their employment agreements) and non-employee directors who held stock options with an exercise price greater than $1.50 were eligible to participate in the Offer. Eligible options that were vested as of August 31, 2006 could be exchanged for restricted stock awards, and eligible options that were not vested as of that date could be exchanged for deferred stock unit awards. Both the restricted stock awards and the deferred stock unit awards are subject to vesting provisions. The number of restricted stock awards and/or deferred stock unit awards issued in exchanged for an eligible option grant was determined by the exchange ratio applicable to that particular option.

The Company had instituted the exchange offer because a considerable number of its employees had held options that had exercise prices higher than the current and recent trading prices of its common stock. The purpose of the exchange offer was to promote the interests of the Company's stockholders by strengthening its ability to motivate and retain valued employees.

The exchange offer began on January 25, 2007 and ended on February 23, 2007. In connection with the Offer, an aggregate of 1,562,000 options were tendered in exchange for an aggregate of 472,471 shares of restricted stock and 394,405 shares of deferred stock unit awards. This represented approximately 95% of the total options that were eligible for exchange. The Company accounted for the exchange of Options for restricted stock and deferred stock unit awards as replacement awards in accordance with SFAS No. 123(R) and recognized an expense of $436,000 for the year ended December 31, 2007.

In February, 2008, the Company delivered 268,572 shares of Restricted Stock Issued in connection with this Offer.

10. Financing Agreement

In July 2005, the Company entered into a new three year revolving credit facility ("Credit Facility") with Wells Fargo Retail Finance, LLC ("Wells Fargo"). The Credit Facility refinanced the Company's previous credit

facility (the "Rosenthal Facility") with Rosenthal & Rosenthal, Inc.

("Rosenthal"). Under the terms of the Credit Facility, Wells Fargo provides the Company with a revolving credit facility and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of the Company's assets. Historically, the Credit Facility was also secured by a $2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). In August 2006, Wells Fargo agreed to release the Soros LC, and no longer requires an availability reserve (although it has the right under the Credit Facility to establish reserves in the future, as it deems appropriate) so long as the Company maintains a minimum cash balance of $5,000,000. Furthermore, our Credit Facility prohibits us from paying cash dividends without the consent of our lender.

Availability under the Credit Facility is determined by a formula that considers a certain percentage of our inventory and a certain percentage of accounts receivable. The maximum availability is currently $7,500,000, but can be increased to $12,500,000 at the Company's request, subject to certain conditions. As of December 31, 2007, total availability under the Credit Facility, was approximately $7,500,000 of which $3,700,000 was committed, leaving approximately $3,800,000 available for further borrowings.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75% for average excess availability less than $3.0 million and the prime rate plus 0.50% or LIBOR plus 2.50% for average excess availability greater than $3.0 million. The Company also pays a monthly commitment fee on the unused portion of the facility (i.e., $7,500,000 less the amount of loans outstanding) equal to 0.35%. The Company also pays Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open. For the years ended December 31, 2007, 2006 and 2005 total interest expense and fees related to the credit facilities totaled approximately $130,000, $170,000 and $196,000, respectively.

Under the terms of the Credit Facility, Soros has the right to purchase all of the Company's obligations from Wells Fargo at any time if it is then in default under the Credit Facility. Subsequent to year end the Credit Facility was Amended - See Note 12 below.

Soros Warrants in Connection with Loan Facility

Prior to April 2004, Soros guaranteed repayment of the Company's previous Loan Facility (the "Soros Guarantee"). The Company issued warrants to Soros in consideration for the establishment and continuance of the Soros Guarantee as described below.

The following table represents the warrants issued to Soros in connection with the Loan Facility:

Number of Warrants	Date Issued	Exercise Price	Expiration Date	Assumptions Under Black-Scholes
100,000	March 31, 2001	$0.88(1)	September 11, 2011	Risk Free Rate - 4.86% Volatility - 117% Term - 5 years
25,000	March 17, 2003	$0.78(2)	March 17, 2013	Risk Free Rate - 3.31% Volatility - 123% Term - 4 years

(1) represents the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance

(2) represents the 10 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance

The Company accounted for the warrants in accordance with Accounting Principles Board Opinion No. 14 ("APB No. 14") by valuing the warrants using the Black-Scholes option pricing model and crediting additional paid in capital. These amounts were amortized to interest expense over the life of the Loan Facility.

11. Quarterly Results of Operations (Unaudited)

Amounts in thousands, except per share data:

	Quarter Ended			
2007	March 31	June 30	September 30	De
Net Sales	$22,108	$21,608	$18,079	
Gross Profit(2)	$ 8,374	$ 8,463	$ 5,728	
Net Loss(2)	$(3,103)	$(2,142)	$(5,028)	
Preferred stock dividends	$ (11)	$ (11)	$ (11)	
Net loss available to common shareholders(2)	$(3,114)	$(2,153)	$(5,039)	
Loss per common share - basic and diluted(2)	$ (0.02)	$ (0.02)	$ (0.04)	

Quarter Ended

2006	March 31	June 30	September 30	De
Net Sales	$16,876	$16,793	$16,322	
Gross Profit	$ 6,839	$ 7,046	$ 6,111	
Net Loss	$(3,264)	$(1,901)	$(3,485)	
Preferred stock dividends	$(1,231)	$ (990)	$ (16)	
Net loss available to common shareholders	$(4,495)	$(6,748)	$(3,501)	
Loss per common share - basic and diluted(1)	$ (0.22)	$ (0.17)	$ (0.03)	

(1) Weighted average shares increased to 80.2 million for the year ended December 31, 2006 as a result of the June 2006 financing and the conversion of the Company's preferred stock into common stock in connection with the financing.
(2) Amount includes a write-off of approximately $1.5 million of inventory recorded in the fourth quarter.

12. Subsequent Events

2008 Financing
In March 2008, the Company entered into an agreement (the "Commitment") Soros and private funds associated with Maverick Capital, Ltd. ("Maverick") pursuant to which they agreed to provide up to $3 million of debt financing to the Company, on a standby basis, during the next year, provided that the

commitment amount will be reduced by the gross proceeds of any equity financing consummated during the year. The Company can draw down debt in one or more tranches, provided that our cash balances are less than $1 million at the time of any draw down. The draw downs will be evidenced by subordinated convertible notes (the "Subordinated Notes") that have a term expiring on the later of June 26, 2011 and three years from the date of the issuance of the Subordinated Notes and bear interest at the rate of 8% per annum, compounded annually. Interest is payable upon maturity or conversion. The Subordinated Notes are convertible, (subject to stockholder approval to the extent required by the NASDAQ Capital Market) at the holder's option (a) into equity securities that the Company might issue in any subsequent round of financing at a price that was equal to the lowest price per share paid by any investor in such subsequent round of financing or (b) into Common Stock at a price per share equal to the market price (as defined in the Subordinated Notes) on the date of issuance of the note. In connection with the Commitment, the Compnay issued warrants to Soros and Maverick to purchase an aggregate of 525,002 shares of Common Stock at an exercise price equal to the trailing 20-day average stock price on the date of grant.

Wells Fargo Amendment
On March 26, 2008, the Company amended its credit facility ("Credit

Facility") with Wells Fargo Retail Finance, LLC. ("Wells Fargo") to (i) extend the term until July 26, 2011; (ii) change the rate at which interest accrues on the average daily amount under the Credit Facility during the preceding month to a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 3.25% on average excess availability less than $3.0 million and prime rate plus 0.50% or LIBOR plus 3% on average excess availability greater than $3.0 million; (iii) increase the monthly commitment fee on the unused portion of the Credit Facility to 0.50% from 0.35%; (iv) include a servicing fee of $3,333.33 per month; (v) increase the early termination fee to 1% of the revolving credit ceiling, from 0.50% through maturity; and (vi) amend the standby and documentary letter of credit fees to 3.25% and 2.75%, respectively on average excess availability less than $3.0 million, and 3.00% and 2.50%, respectively on average excess availability greater than $3.0 million.

In addition, the amendment calls for no revolving credit loans to be made unless the full amount available pursuant to the Subordinated Notes (described above) has been advanced to the Company and is outstanding. Under the terms of a Subordination and Intercreditor Agreement, dated as of March 26, 2008, Soros and Maverick have the right to purchase all of the Company's obligations from Wells Fargo at anytime if the Company is then in default under the Credit Facility. In connection with this amendment, the Company paid Wells Fargo a $35,000 amendment fee.

Reverse Stock Split

In March 2008, the Company announced that it would effect a reverse stock split (the "Reverse Stock Split") in order to regain compliance with the minimum bid price requirement of the Nasdaq rules. In connection with the Reverse Stock Split holders of the Company's Common Stock would receive one share of Common Stock for every 10 shares of Common Stock that they held as of April 3, 2008, the record date. The effective date of the Reverse Stock Split is expected to be April 3, 2008.

Upon effectiveness of the Reverse Stock Split, the number of weighted shares outstanding and the loss per share on a proforma basis would be as follows:

	Unaudited		
	December 31, 2007	December 31, 2006	December 31, 2005
Weighted Average Shares Outstanding	13,091,129	8,017,053	1,615,302
Loss Per Share	$(1.21)	$(2.28)	$(5.43)

Schedule II - Valuation and Qualifying Accounts
For the Three Years Ended December 31, 2007

Column A	Column B	Column C		C
		(1)	(2)	

Description	Beginning Balance at January 1, 2007	Charged to Costs and Expenses	Charged to other Accounts	D
Allowance for Sales Returns	(5,043,000)	(59,107,000)	-	5
Allowance for Doubtful Accounts	(397,000)	(669,000)	-	
Inventory Reserves	(1,055,000)	(2,735,000)	-	
Deferred Tax Valuation Allowance	(34,459,000)	(5,460,000)	476,000	

Column A	Column B	Column C		C
		(1)	(2)	
Description	Beginning Balance at January 1, 2006	Charged to Costs and Expenses	Charged to other Accounts	D
Allowance for Sales Returns	(3,407,000)	(50,126,000)	-	4
Allowance for Doubtful Accounts	(78,000)	(643,000)	-	
Inventory Reserves	(782,000)	(1,000,000)	-	
Deferred Tax Valuation Allowance	(30,712,000)	(4,656,000)	909,000	

Column A	Column B	Column C		C
		(1)	(2)	
Description	Beginning Balance at January 1, 2005	Charged to Costs and Expenses	Charged to other Accounts	D
Allowance for Sales Returns	(2,174,000)	(34,820,000)	-	3
Allowance for Doubtful Accounts	(44,000)	(270,000)	-	
Inventory Reserves	(835,000)	(659,000)	-	
Deferred Tax Valuation Allowance	(28,738,000)	(1,533,000)	(441,000)	