BLUEFLY INC
Form 10-K
February 28, 2007

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, 2006

[ ] 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 (State or other jurisdiction of incorporation or organization)	13-3612110 (I.R.S. Employer Identification No.)
42 West 39th Street, New York, NY (Address of principal executive offices)	10018 (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 Boston Stock Exchange

Securities registered under Section 12(g) of the Exchange 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 an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes [ ] No [X]

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

Yes [ ] No [X]

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

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

As of February 23, 2007, there were 130,494,214 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 30, 2006, based upon the last sale price of such equity reported on the Nasdaq Capital Market, was approximately $22,064,000.

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 2007 Annual Stockholders Meeting, which will be filed with the Securities Exchange Commission.

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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 2006, 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 960,000 customers and shipped to over 14 countries.

Our common stock is listed on the Nasdaq Capital Market under the symbol "BFLY" and on the Boston Stock Exchange under the symbol "BFL" 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.

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 normally found only at outlet stores and off-price stores. 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 the ComScore Networks, e-commerce non travel retail spending (excluding auctions and large corporate purchases) eclipsed $100 billion in 2006 for the first time, while growth remained strong 24 percent increase compared to 2005. During the holiday shopping season alone, consumers spent $24.6 billion, a 26% increase over the $19.6 billion spent in the previous year, according to ComScore.

According to the Annual E- Commerce Survey performed by Cowen and Company, 41% of consumers plan to increase e-commerce spending in 2007, primarily due to the convenience of online shopping. The survey also states that underlying trends in e-commerce remain strong and Cowen and Company expect that US e-commerce sales will grow 20% in 2007.

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.

From 2001 through 2005, we acquired new customers primarily through online advertising, word-of-mouth, sweepstakes and our affiliate program. Although we had not allocated significant resources to branding or to more traditional advertising channels such as print during this time, our customer file continued to grow. In September 2005, we began a national advertising campaign that featured both print and television, and we have expanded that campaign over the past 18 months.

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 opening up more than 200 direct supply 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.

During 2004, we re-focused our merchandising strategy to offer more in-season merchandise and to cover the latest trends, while continuing to offer a premium selection of brands. We continue to refine this strategy. As a result of this merchandise strategy, we were able to increase our gross margins to their highest levels ever - 40.1% in 2006 from 29.9% in 2003.

WAREHOUSING AND FULFILLMENT

When we receive an order, the information is transmitted to our third party warehouse and fulfillment center located in Virginia, 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.

We focus on customer satisfaction throughout our organization. In December 2006, during our peak weeks of the holiday season, the vast majority of our orders were shipped within one business day from receipt of the customer's order.

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 or telephone assistance, customer service representatives are available seven days a week to provide assistance. We utilize customer representatives from third party call centers that have teams 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 on-line 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 third quarter of 2007 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 Certain Key Personnel."

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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. Although we believe that we compare favorably with our competitors, we recognize that this market is relatively new and is evolving rapidly, and, accordingly, there can be no assurance that this will continue to be the case.

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 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 February 23, 2007, we had 95 full-time employees and 1 part-time employee, as compared to 84 full-time and 2 part-time employees as of February 23, 2006. 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, 2006, we had an accumulated deficit of $115,997,000. We incurred net losses of $12,193,000, $3,820,000 and $3,791,000 for the years ended December 31, 2006, 2005 and 2004, respectively. We have incurred substantial costs to develop our Web site and infrastructure. 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 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 February 23, 2007, affiliates of Soros Fund Management LLC ("Soros") beneficially owned, in the aggregate, approximately 39% of our Common Stock. Private funds

associated with Maverick Capital, Ltd. ("Maverick"), and investment entities and accounts managed and advised by Prentice Capital Management, LP ("Prentice") each owned approximately 24% 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. Soros, Maverick and Prentice also have a right of first refusal (the "Right of First Refusal") to provide the financing in any private placement of our Common Stock that we seek to consummate within on or prior to June 15, 2007 on a pro rata basis.

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.

Our Lenders Have 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.

If Our Co-Location Facility, Third Party Distribution Center Or Third Party Call Centers Fail, Our Business Could Be Interrupted For A Significant Period Of Time. Our ability to receive and fulfill orders successfully and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications hardware systems and fulfillment center. Substantially all of our computer and communications hardware is located at a single co-location facility owned by a third party in New York City. Primarily all of our inventory is held, and our customer orders are filled, at a third party distribution center located in Virginia, and a large majority of our customer service representatives are employees of third party call centers in Ohio and Maine. These operations are vulnerable to damage or interruption from fire, flood, storms, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not presently have redundant systems in multiple locations or a formal disaster recovery plan. Accordingly, a failure at one of these facilities could interrupt our business for a significant period of time, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Any such interruption would negatively impact our sales, results of operations and cash flows for the period in which it occurred, and could have a long-term adverse effect on our relationships with our customers and suppliers.

Our Ability To Maintain Our Minimum Availability Requirement 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 2006, we purchased approximately 28% 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.

The Implementation Of The New Web Site May Place A Significant Strain On Our Key Personnel. 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 third quarter of 2007 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.

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.

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 UPS, DHL 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.

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 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."

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 2006, 2005 and 2004 has been 39.6%, 37.8% and

36.6%, 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, Chief Financial Officer and Chief Marketing Officer run through July 2009, July 2009 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

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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 Virginia, Ohio, New Jersey, Maine 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 Virginia, Ohio, New Jersey, Maine 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.

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. Management will be responsible for assessing the design and the effectiveness of our internal controls for the year ending December 31, 2007. Our independent registered 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 management's assessment of 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 2008 through 2010. Our total lease expense for the current office space during 2006 was approximately $457,000.

ITEM 3. LEGAL PROCEEDINGS

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 2006.

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 and the Boston Stock Exchange. The following table sets forth the high and low bid prices for the Common Stock for the periods indicated, as reported by the Nasdaq Capital Market:

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

FISCAL 2005	HIGH	LOW
First Quarter	$ 2.34	$ 1.22
Second Quarter	$ 2.24	$ 1.20
Third Quarter	$ 1.88	$ 1.40
Fourth Quarter	$ 1.87	$ 0.97

HOLDERS

As of February 23, 2007, there were approximately 115 holders of record of the Common Stock. We believe that there were more than 5,000 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 contain restrictions on our ability to declare or pay dividends. 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.

PERFORMANCE GRAPH

Comparison of Five-Year Cumulative Total Returns
Performance Report for
BLUEFLY INC

Produced on 02/20/2007 including data to 12/29/2006

[Performance Graph Appears Here]

Company Index: BLUEFLY INC

Market Index: Nasdaq Stock Market (US Companies)

Peer Index: Nasdaq Retail Trade Stocks

SIC 5200-5599, 5700-5799, 5900-5999 US & Foreign

Date	Company Index	Market Index	Peer Index
12/31/2001	100.000	100.000	100.000
01/31/2002	95.789	99.239	101.593
02/28/2002	78.684	88.920	98.443
03/28/2002	94.737	94.751	100.313
04/30/2002	76.316	86.879	105.119
05/31/2002	91.579	83.047	104.808
06/28/2002	68.421	75.525	102.677
07/31/2002	47.895	68.628	88.398
08/30/2002	52.632	67.899	85.127
09/30/2002	44.737	60.597	82.364
10/31/2002	36.842	68.875	89.156
11/29/2002	62.105	76.553	92.289
12/31/2002	86.316	69.131	84.968
01/31/2003	51.053	68.383	81.658
02/28/2003	41.579	69.344	81.585
03/31/2003	43.158	69.544	82.668
04/30/2003	43.158	75.865	91.890
05/30/2003	71.053	82.526	96.778
06/30/2003	58.947	83.850	97.721
07/31/2003	56.316	89.627	103.696
08/29/2003	52.632	93.536	110.968
09/30/2003	77.895	92.320	105.508
10/31/2003	136.842	99.753	118.094
11/28/2003	251.579	101.232	119.593
12/31/2003	213.158	103.365	118.315
01/30/2004	215.263	106.429	119.724
02/27/2004	195.789	104.426	123.573
03/31/2004	168.421	102.648	124.074
04/30/2004	142.105	99.246	122.562
05/28/2004	142.158	102.543	126.344
06/30/2004	113.158	105.693	133.772
07/30/2004	95.263	97.626	128.665
08/31/2004	109.474	95.235	126.442
09/30/2004	90.526	98.077	131.420
10/29/2004	150.474	102.053	139.122
11/30/2004	131.579	108.341	146.381
12/31/2004	122.105	112.489	150.068
01/31/2005	86.842	106.636	144.848
02/28/2005	68.421	106.030	145.142
03/31/2005	75.789	103.334	147.157
04/29/2005	67.895	99.574	140.770
05/31/2005	86.316	107.273	153.690
06/30/2005	94.737	106.838	154.571
07/29/2005	84.737	113.656	163.304
08/31/2005	82.632	111.853	150.690
09/30/2005	80.526	111.942	146.235
10/31/2005	85.789	110.504	150.102
11/30/2005	76.316	116.531	153.877
12/30/2005	58.947	114.881	151.492

01/31/2006	57.368	119.953	154.954
02/28/2006	56.842	118.760	156.671
03/31/2006	58.421	121.855	165.355
04/28/2006	58.947	120.896	166.116
05/31/2006	36.853	113.603	160.218
06/30/2006	63.684	113.602	161.553
07/31/2006	54.737	109.270	149.288
08/31/2006	55.263	114.122	148.436
09/29/2006	52.105	118.051	160.496
10/31/2006	47.368	123.832	170.228
11/30/2006	46.316	127.068	165.849
12/29/2006	67.368	126.212	165.445

This performance graph shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") or otherwise subject to the liabilities under that Section and shall not be deemed to be incorporated by reference into any filing of Bluefly under the Securities Act of 1933, as amended or the Exchange Act.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with the consolidated 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, 2003 and 2002 and at December 31, 2004, 2003 and 2002 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. All data is in thousands, except share data:

	Year Ended Decemb		
	2006	2005	2004
Statement of Operations Data:			
Net sales	$ 77,062	$ 58,811	$ 43,799
Cost of sales	46,153	35,816	27,393
Gross profit	30,909	22,995	16,406
Selling and fulfillment expenses	15,808	12,880	11,783
Marketing expenses	14,196	6,961	2,120
General and administrative expenses	13,001	6,299	6,408
Total operating expenses	43,005	26,140	20,311
Operating loss	(12,096)(3)	(3,145)	(3,905)
Interest expense	(599)	(856)	(733)
Interest/other income	502	181	847

Net loss	(12,193)	(3,820)	(3,791)
Basic and diluted loss per share:	$ (0.23)	$ (0.54)	$ (0.55)
Basic and diluted weighted average number of common shares outstanding available to common stockholders(2)	80,170,532	16,153,020	14,586,752

	As of Decembe		
	2006	2005	2004
Balance Sheet Data:			
Cash and cash equivalents	$ 20,188	$ 9,408	$ 7,938(
Inventories, net	24,189	16,893	12,958
Other current assets	4,229	3,536	2,559
Total assets	52,430	33,045	25,541
Current liabilities	14,603	11,936	9,413
Long term liabilities	--	5,244	4,739
Shareholders' equity	37,827	15,865	11,389

(1) Includes restricted cash of $1,253
(2) Weighted average shares increased to 80.2 million in 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.
(3) This amount includes non-cash expense of approximately $4.5 million related to stock-based compensation, recorded in accordance with SFAS 123R.

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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 consolidated 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. Over the past five years our sales have grown at a compounded annual growth rate of more than 28%, while our gross margin percentage has increased from 30.5% in 2001 to 40.1% in 2006.

The recent increase in our margin and sales is the direct result of a new merchandise strategy that we began to implement in spring 2004. As part of that strategy we are bringing current season merchandise and the latest fashion trends to our customer for great value. While there will be some fluctuation in our gross margin percentage from quarter to quarter as we further develop our merchandising and marketing strategy, we believe that we will be able to maintain margins at the current levels.

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 launched a national advertising campaign in 2005, and have continued and expanded upon it in the last eighteen months. We intend to continuously review the results of the campaign and use the learnings to refine and improve upon our marketing strategy.

Our net sales increased over 31% to $77,062,000 for the year ended December 31, 2006 from $58,811,000 for the year ended December 31, 2005. Our gross margin increased to 40.1% in 2006 from 39.1% in 2005, 37.5% in 2004, 29.9% in 2003 and 32.8% in 2002. Our gross profit increased by more than 34% to $30,909,000 for the year ended December 31, 2006 from $22,995,000 for the year ended December 31, 2005. This growth in gross profit was driven by the increase in net sales, and by the increase in gross margins. Our operating loss increased by over 284%, to $12,096,000 in 2006, from $3,145,000 in 2005.

Total marketing expenses increased by 104% to $14,196,000 for the full year 2006, from $6,961,000 for the full year 2005. We increased our spending in marketing (excluding staff related costs) by 102% to $12,602,000 for the full year 2006, from $6,250,000 for the full year 2005. 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 national advertising campaign. For the first three quarters of 2006, our net sales increased by approximately 25%, 40% and 36%, respectively, as compared to the same periods in 2005. In general, we intend to market our business more aggressively than we have in previous years. This more aggressive growth strategy will cause our marketing expense as a percentage of revenue to increase in the short-term; however, we believe that it 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 increased to 39.6% of gross sales for the year ended December 31, 2006 compared to 37.8% in 2005. The increase was primarily caused by a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

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 in a prior season and have determined to hold for the next selling season, subject (in some cases) to appropriate mark-downs. 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.

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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 $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, 2006, we had an accumulated deficit of $115,997,000. 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 non-cash beneficial conversion charges resulting from decreases in the conversion price of our Preferred Stock of approximately $33.0 million, and non-cash charges of approximately $4.5 million in connection with the adoption of SFAS 123(R). 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 judgements 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.

Stock-Based Compensation

As of January 1, 2006, we adopted SFAS 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:

	2006		2005		20
		As a % of Net Sales		As a % of Net Sales	
Net sales	$ 77,062	100.0%	$ 58,811	100.0%	$ 43,799
Cost of sales	46,153	59.9%	35,816	60.9%	27,393
Gross profit	30,909	40.1%	22,995	39.1%	16,406
Marketing expenses	14,196	18.4%	6,961	11.8%	2,120
Selling and fulfillment expenses	15,808	20.5%	12,880	21.9%	11,783
General and administrative expenses	13,001	16.9%	6,299	10.7%	6,408
Total operating expenses	43,005	55.8%	26,140	44.4%	20,311
Operating loss	(12,096)	(15.7)%	(3,145)	(5.3)%	(3,905)
Interest (expense) other income	(97)	(0.1)%	(675)	(1.2)%	114

Net loss	$(12,193)	(15.8)%	$ (3,820)	(6.5)%	$ (3,791)

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:

	2006	2005	2004
Average Order Size (including shipping & handling)	$ 257.64	$ 220.17	$ 188.51
New Customers Added during the Year*	177,213	148,975	127,177

* Based on unique email addresses

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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 represents 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 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, 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. While we believe that we can continue to generate gross margin at or near these levels in the future, we believe that it may be difficult for us to continue to increase the gross margin level at the rate that we have over the past few years.

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). We significantly increased our national advertising campaign during 2006, and we plan to continue to grow our national advertising campaign during the next 12-months. We spent approximately $7.1 million and $3.2 million on our national advertising campaign in 2006 and 2005, respectively, and we expect to spend approximately $7.2 million in 2007.

Marketing expenses include expenses related to our national ad campaign, online and print advertising, "sweepstakes" promotions as well as staff related costs. Marketing expenses increased by a higher percentage than revenue as a result of the costs associated with our national marketing campaign. Costs in connection with this campaign are being recorded as the magazines and commercials are being released. As a result, we expect marketing expense as a percentage of revenue to increase in the short-term. We believe that this 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 on a customer's first order.

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

	Year Ended December 31, 2006	Year Ended December 31, 2005	Percentage Dif increase (dec
Operating	8,353,000	6,925,000	
Technology	4,203,000	3,567,000	
E-Commerce	3,252,000	2,388,000	
	$ 15,808,000	$ 12,880,000	

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Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. 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 remained relatively unchanged at $1.8 million, as the current year fees 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.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. 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.

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, 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.

The increase was offset partially from economies of scale in our operations and technology expenses, as some of the fixed costs involved in maintaining our Web site and processing orders were allocated over a larger number of orders. One of our goals is to achieve greater economies of scale as our business grows, although there can be no assurance that we will be successful in doing so. We plan to continue to invest in all of these areas in the near term in order to grow our business.

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, 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 2006. Most of these bonuses are 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.

In January 2007, we commenced an exchange offer pursuant to which we offered to exchange certain outstanding stock options issued to employees and non-employee directors for restricted stock awards and/or deferred stock unit awards. See Footnote 15 "Subsequent Events" to our financial statements for additional information regarding the exchange offer.

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.

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Interest expense, which is comprised primarily of interest paid on our loan

facility and convertible notes held by Soros. 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.

Net loss per share: Net loss per share decreased to $0.23 per share from $0.54 per share, as the number of weighted average shares outstanding increased to 80.2 million in 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.

FOR THE YEAR ENDED DECEMBER 31, 2005 COMPARED TO THE YEAR ENDED DECEMBER 31, 2004

Net sales: Gross sales for the year ended December 31, 2005 increased by approximately 37% to $94,586,000 from $69,032,000 for the year ended December 31, 2004. The provision for returns and credit card chargebacks and other credits was approximately 38% for 2005 and 37% for 2004, resulting in a provision of $35,775,000 for the year ended December 31, 2005 and $25,233,000 for the year ended December 31, 2004.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2005 were $58,811,000. This represents an increase of over 34% compared to the year ended December 31, 2004, in which net sales totaled $43,799,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 17% higher than the full year 2004) and an increase in the number of new customers acquired (approximately 17% higher than the full year 2004). Shipping and handling revenue (which is included in net sales) increased by 16% to $3,874,000 for the year ended December 31, 2005, from $3,353,000 for the year ended December 31, 2004. 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 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, 2005 totaled $35,816,000, resulting in gross margin of approximately 39.1%. Cost of sales for the year ended December 31, 2004 totaled $27,393,000, resulting in gross margin of 37.5%. 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. As our inventory composition was heavily weighted with newer higher margin product there was less lower margin inventory to negatively affect the margins than there was in 2004.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by over 40%, to $22,995,000 for the year ended December 31, 2005, from $16,406,000 for the year ended December 31, 2004.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 42% for the year 2005 compared to the year ended 2004. The selling, marketing and fulfillment expenses were comprised of the following:

	Year Ended December 31, 2005	Year Ended December 31, 2004	Percentage Dif increase (dec
Marketing	$ 6,961,000	$ 2,120,000	

Operating	6,925,000	5,848,000
Technology	3,567,000	4,086,000
E-Commerce	2,388,000	1,849,000
	$ 19,841,000	$ 13,903,000

As a percentage of net sales, our selling, marketing and fulfillment expenses increased to 33.7% for the year ended December 31, 2005 from 31.7% for the year ended December 31, 2004. The increase in selling, marketing and fulfillment expenses as a percentage of net sales resulted primarily from costs associated with our national advertising campaign (which was launched in September 2005). The increase was offset partially from economies of scale in our operations and technology expenses, as some of the fixed costs involved in maintaining our Web site and processing orders were allocated over a larger number of orders

Marketing expenses include expenses related to our national ad campaign, online and print advertising, "sweepstakes" promotions as well as staff related costs. Marketing expenses increased by a higher percentage than revenue as a result of the

costs associated with our national marketing campaign. Costs in connection with this campaign are being recorded as the magazines and commercials are being released. For the year ended December 31, 2005, approximately $3.2 million was expensed in connection with this campaign.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in 2005 by over 18% compared to 2004 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 was offset by costs associated with our 2004 temporary clearance store, which closed in April 2005. 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 30% to $1.7 million from $1.3 million and credit card fees increased by over 29% to $1.8 million from $1.4 million. Both expenses remained relatively constant as a percentage of gross sales at 2% for 2005 and 2004.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the year ended December 31, 2005, technology expenses decreased by approximately 13% compared to the year ended December 31, 2004. This decrease resulted from a decrease in headcount and salary related expenses, a decrease in depreciation expense, and a decrease in web hosting expense. These factors were partially offset by an increase in the costs associated with software support. Depreciation expense for the year ended December 31, 2005 was lower than depreciation for the year ended December 31, 2004 due to the fact that costs associated with our current platform as well as certain computer equipment was fully depreciated during 2004.

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, 2005, this amount increased by approximately 29% as compared to the year ended December 31, 2004, primarily due to an increase in salary related expenses as well as an increase in expenses associated with third party software, third party analytics services and our increased use of outside models for photo shoots.

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, 2005 decreased slightly to $6,299,000 for the year ended December 2005 as compared to $6,408,000 for the year ended December 31, 2004. The slight decrease in general and administrative expenses was the result of decreased salary and benefit expenses, offset by an increase in public company expenses, and increases in consulting and accounting fees.

As a percentage of net sales, general and administrative expenses decreased to 10.7% in 2005 from 14.6% in 2004.

Loss from operations: Operating loss decreased by over 19% in 2005, to $3,145,000 from $3,905,000 in 2004 as a result of the increase in gross profit.

Interest expense and interest and other income, net: Interest and other income for year ended December 31, 2005 decreased to $181,000 from $847,000 for the year ended December 31, 2004. Interest and other income was higher in 2004 primarily because of $564,000 in non-cash income recognized in 2004 to adjust a liability associated with warrants issued by us to their fair value as of June 17, 2004 (at which time the warrants were re-classified as equity as described in Note 6 to our financial statements), as well as $169,000 realized in 2004 in connection with the judgment we received in the Breider Moore litigation.

Interest expense for the year ended 2005 totaled $856,000 compared to $733,000 for the year ended 2004, and related primarily to fees paid in connection with the Loan Facility and interest expense on Convertible Notes held by Soros.

LIQUIDITY AND CAPITAL RESOURCES

General

At December 31, 2006, we had approximately $20.2 million in the form of cash and cash equivalents. Working capital at December 31, 2006 and 2005 was $34.0 million and $17.9 million, respectively. In addition, as of December 31, 2006, we had approximately $3.2 million committed under the Credit Facility, leaving approximately $4.3 million of availability, compared to availability of $3.75 million at December 31, 2005.

We fund our operations through cash on hand, operating cash flow, as well as the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates. Any deterioration in any of these financial measures would have a negative impact on our liquidity. Total availability under the Credit Facility 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 also 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, 2006, we had approximately $616,000 of prepaid inventory and $102,000 of prepaid marketing expense on our balance sheet.

Our inventory levels as of December 31, 2006 were approximately $7.3 million higher than at December 31, 2005. The increase in inventory generally reflects a ramp up in connection with our sales growth as well as opportunistic buying of fresh inventory that has not previously been available to us 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.

On June 15, 2006, we raised $50 million of additional capital through the sale of 60,975,610 shares of our Common Stock. We used $25 million of the proceeds from such sale to pay all accrued but unpaid dividends on the Preferred Stock converted by Soros in connection with such sale and to payoff the convertible promissory notes held by Soros. The remaining proceeds from the sale will be used for general corporate purposes. We believe that our current funds, together with working capital, and operating cash flow, and availability under our existing Credit Facility 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 ("Credit Facility") with Wells Fargo Retail Finance, LLC ("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). In return, we agreed to maintain a minimum cash balance of $5,000,000. Availability under the Credit Facility is determined by a formula that takes into account the amount of our inventory and 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, 2006, total availability under the Credit Facility was approximately $7,500,000 of which $3,200,000 was committed, leaving approximately $4,300,000 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%. 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.

Under the terms of the Credit Facility, Soros has the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

Commitments and Long Term Obligations

As of December 31, 2006, 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	1,068,000	1,068,000	--	--	--
Purchase Orders	6,010,000	6,010,00	--	--	--
Operating Leases	1,421,000	381,000	1,040,000	--	--

Capital Leases	13,000	13,000	--	--	--
Employment Contracts	3,778,000	1,990,000	1,788,000	--	--
Technology	208,000	208,000	--	--	--
Grand total	$ 12,498,000	$ 9,670,000	$ 2,828,000	--	--

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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 Footnote 9 to the financial statements and the Statement of Shareholders' Equity for more information.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 157, Fair Value Measurements ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. The Company is evaluating the potential effects of adopting SFAS 157, and does not expect the adoption to have a material impact on its financial condition and results of operations.

In September 2006 the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108") which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The adoption of this pronouncement will not have an impact on the Company's financial statements.

In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires an entity to recognize the impact of a tax position in its financial statements if that position is more likely than not to be sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of fiscal year 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. Early application of FIN 48 is encouraged. The Company is still evaluating the timing of its adoption of FIN 48 and the potential effects of implementing this Interpretation on its financial condition and results of operations but does not expect its adoption to have a material effect on its results of operations due to the fact that the Company has significant historical losses.

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.

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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.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. 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 in ensuring that information required to be disclosed by us 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.

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

None.

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 2007 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 2007 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 2007 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 2007 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 2007 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, 2006 and 2005
Statements of Operations for the three years ended December 31, 2006, 2005 and 2004
Statements of Changes in Shareholders' Equity for the three years ended December 31, 2006, 2005 and 2004 Statements of Cash Flows for the three years ended December 31, 2006, 2005 and 2004 Notes to Financial Statements

2. Financial Statement Schedules:
Schedule II - Valuation and Qualifying Accounts

3. Exhibits:

EXHIBIT NO.	DESCRIPTION
3.1 (e)	Certificate of Incorporation of the Company.
3.2 (e)	By-Laws of the Company.
3.6 (n)	Certificate of Powers, Designations, Preferences and rights of Series F Preferred Stock of the Company.
10.1 (c)	Amended and Restated 1997 Stock Option Plan.
10.2 (a)	Lease Agreement by and between the Company and John R. Perlman, et al., dated as of May 5, 1997.
10.3 (b)	Lease by and between the Company and Adams & Co. Real Estate, Inc., dated March 22, 1999.

10.4 (c)	Lease by and between the Company and Adams & Co. Real Estate, Inc., dated May 4, 2000.
10.5 (d)	Bluefly, Inc. 2000 Stock Option Plan.
10.6 (d)	Investment Agreement, dated November 13, 2000, by and among the Company, Bluefly Merger Sub, Inc., Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
*10.7 (e)	Software License and Services Agreement, dated March 12, 2002, by and among the Company and Blue Martini Software, Inc.
10.8 (f)	Warrant No. 1 dated March 27, 2002, issued to Quantum Industrial Partners LDC.
10.9 (f)	Warrant No. 2 dated March 27, 2002, issued to SFM Domestic Investments LLC.
10.10 (f)	Warrant No. 3 dated March 30, 2002, issued to Quantum Industrial Partners LDC.
10.11 (f)	Warrant No. 4 dated March 30, 2002, issued to SFM Domestic Investments LLC.
10.12 (g)	Common Stock and Warrant Purchase Agreement, dated May 24, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto.
10.13	Employment Agreement, dated as of November 14, 2006, by and between the Company and Patrick Barry.
10.14 (h)	Note and Warrant Purchase Agreement, dated January 28, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.

10.15 (h)	Warrant No. 1 dated January 28, 2003, issued to Quantum Industrial Partners LDC.
10.16 (h)	Warrant No. 2 dated January 28, 2003, issued to SFM Domestic Investments LLC.
10.17 (h)	Warrant No. 4 dated March 17, 2003, issued to Quantum Industrial Partners LDC.
10.18 (h)	Warrant No. 5 dated March 17, 2003, issued to SFM Domestic Investments LLC.
10.19	Employment Agreement dated as of November 14, 2006 by and between Bluefly, Inc. and Melissa Payner-Gregor.
10.20 (i)	Common Stock and Warrant Purchase Agreement dated January 9, 2004 by and among the Company and the Investors listed on Schedule 1 thereto.
*10.21 (j)	CallTech Master Agreement for Outsourcing Contact Center Support, dated as of August 5, 2004, by and between the Registrant and CallTech Communications, LLC.

10.22 (k)	Bluefly, Inc. 2005 Stock Incentive Plan.
*10.23 (l)	Master Service Agreement, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC.
*10.24 (l)	Customer Order Addendum, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC.
*10.25 (m)	Master Services Agreement, dated as of March 21, 2005, by and between the Company and NewRoads, Inc.
*10.26 (m)	Statement of Work 1 by and between the Company and NewRoads, Inc.
10.27 (n)	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.
10.28 (o)	Loan and Security Agreement, dated July 26, 2005, by and between the Company and Wells Fargo Retail Finance, LLC.
10.29 (p)	Employment Agreement, dated as of September 19, 2005, by and between the Company and Bradford Matson.
10.30 (q)	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.
10.31 (q)	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.
10.32 (q)	Fee Letter, dated June 5, 2006, by and among Bluefly, Inc., Quantum Industrial Partners LDC and SFM Domestic Investments, LLC.
10.33 (q)	Waiver Letter, dated June 5, 2006, by and between Bluefly, Inc. and Wells Fargo Retail Finance, LLC.
10.34 (r)	First Amendment to Loan and Security Agreement, dated as of August 14, 2006, by and between the Company and Wells Fargo Retail Finance, LLC
10.35 (s)	Master License Agreement, dated as of September 28, 2006, by and between the Company and Art Technology Group, Inc.

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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.

(a) Incorporated by reference to the Company's Quarterly report filed on Form 10-QSB for the quarterly period ended March 31, 1997.
(b) Incorporated by reference to the Company's Quarterly report filed on Form 10-QSB for the quarterly period ended June 30, 1999.
(c) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2000.
(d) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended September 30, 2000.
(e) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2000.
(f) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2001.
(g) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2002.
(h) Incorporated by reference to the Company's Annual Report filed on Form 10-K for the year ended December 31, 2002.
(i) Incorporated by reference to the Company's current report on Form 8-K, dated January 13, 2004.
(j) Incorporated by reference to the Company's quarterly report on Form 10-Q for the quarterly period ended June 30, 2004.
(k) Incorporated by reference to the Company's annual report on Form 10-K for the year ended December 31, 2005.
(l) Incorporated by reference to the Company's current report on Form 8-K, dated March 4, 2005.
(m) Incorporated by reference to the Company's current report on Form 8-K, dated March 23, 2005.
(n) Incorporated by reference to the Company's current report on Form 8-K, dated June 28, 2005.
(o) Incorporated by reference to the Company's current report on Form 8-K, dated July 29, 2005.
(p) Incorporated by reference to the Company's current report on Form 8-K, dated September 22, 2005.
(q) Incorporated by reference to the Company's current report on Form 8-K, dated June 7, 2006.
(r) Incorporated by reference to the Company's current report on Form 8-K, dated August 14, 2006.
(s) Incorporated by reference to the Company's current report on Form 8-K, dated October 3, 2006.

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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

February 28, 2007

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	February 28,
/s/ Melissa Payner-Gregor Melissa Payner-Gregor	Chief Executive Officer (Principal Executive Officer), President and Director	February 28,
/s/ Patrick C. Barry Patrick C. Barry	Chief Financial Officer and Chief Operating Officer (Principal Accounting Officer)	February 28,
/s/ Barry Erdos Barry Erdos	Director	February 28,
s/Michael Gross Michael Gross	Director	February 28,
/s/ Ann Jackson Ann Jackson	Director	February 28,
/s/ Martin Miller Martin Miller	Director	February 28,
/s/ Neal Moszkowski Neal Moszkowski	Director	February 28,
/s/Christopher McCann Christopher McCann	Director	February 28,
/s/ Alex Rafal Alex Rafal	Director	February 28,

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 accompanying index present fairly, in all material respects, the financial position of Bluefly, Inc. at December 31, 2006 and December 31, 2005, and the results of its operations and its cash flows for each of the three years in the period ended

December 31, 2006 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 accompanying index 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 stock-based compensation in 2006.

/s/ PricewaterhouseCoopers LLP

New York, New York
February 26, 2007

BLUEFLY, INC.
BALANCE SHEETS
DECEMBER 31, 2006 AND 2005
(dollars rounded to the nearest thousand)

	2006
ASSETS	
Current assets	
Cash and cash equivalents	$ 20,188,000
Inventories, net	24,189,000
Accounts receivable, net of allowance for doubtful accounts	2,719,000
Prepaid expenses and other current assets	1,510,000
Total current assets	48,606,000
Property and equipment, net	3,573,000
Other assets	251,000
Total assets	$ 52,430,000
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$ 4,822,000
Allowance for sales returns	5,043,000
Accrued expenses and other current liabilities	1,908,000
Deferred revenue	2,830,000
Total current liabilities	14,603,000

Notes payable to related party shareholders	-
Long-term interest payable to related party shareholders	-
Long-term obligations under capital lease	-
Total liabilities	14,603,000
Commitments and contingencies (Note 8)	
Shareholders' equity	
Series A Preferred Stock - $.01 par value; 500,000 shares authorized, 0 and 460,000 shares issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2005: $9.2 million plus $5.9 million of accrued dividends)	-
Series B Preferred Stock - $.01 par value; 9,000,000 shares authorized, 0 and 8,889,414 shares issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2005: $30 million plus $9.5 million of accrued dividends)	-
Series C Preferred Stock - $.01 par value; 3,500 shares authorized, 0 and 1,000 shares issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2005: $1 million plus $286,000 of accrued dividends)	-
Series D Preferred Stock - $.01 par value; 7,150 shares authorized, 0 and 6,313.43 shares issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2005: $6.3 million plus $2.4 million of accrued dividends)	-
Series E Preferred Stock - $.01 par value; 1,000 shares authorized, 0 and 1,000 issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2005: $1.0 million plus $347,000 of accrued dividends)	-
Series F Preferred Stock - $.01 par value; 7,000 shares authorized, 571.43 and 5,279.714 issued and outstanding as of December 31, 2006 and 2005, respectively (liquidation preference at December 31, 2006: $571,000 plus $62,000 of accrued dividends, at December 31, 2005: $5.3 million plus accrued dividends of $192,000)	-
Common Stock - $.01 par value; 152,000,000 and 92,000,000 shares authorized, 130,484,854 and 19,059,166 shares issued and outstanding as of December 31, 2006 and 2005, respectively	1,305,000
Additional paid-in capital	152,519,000
Accumulated deficit	(115,997,000)
Total shareholders' equity	37,827,000
Total liabilities and shareholders' equity	$ 52,430,000

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

BLUEFLY, INC.
STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004
(dollars rounded to the nearest thousand)

	2006	2005	20

Net sales	$ 77,062,000	$ 58,811,000	$ 43,
Cost of sales	46,153,000	35,816,000	27,
Gross profit	30,909,000	22,995,000	16,
Marketing expenses	14,196,000	6,961,000	2,
Selling and fulfillment expenses	15,808,000	12,880,000	11,
General and administrative expenses	13,001,000	6,299,000	6,
Total operating expenses	43,005,000	26,140,000	20,
Operating loss	(12,096,000)	(3,145,000)	(3,
Interest expense	(599,000)	(856,000)	(
Interest income	502,000	181,000	
Other income (Note 6)	-	-	
Net loss	(12,193,000)	(3,820,000)	(3,
Preferred stock dividends	(2,252,000)	(4,958,000)	(4,
Deemed dividend related to beneficial conversion feature on Series F Preferred Stock	(3,857,000)	-	
Net loss available to common shareholders	$ (18,302,000)	$ (8,778,000)	$ (8,
Basic and diluted loss per common share	$ (0.23)	$ (0.54)	$
Weighted average number of shares outstanding used in calculating basic and diluted loss per common share	80,170,532	16,153,020	14,

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, 2006, 2005 AND 2004
(Dollars rounded to the nearest thousand)

	SERIES A PREFERRED STOCK $.01 PAR VALUE		SERI PREFERR $.01 PA
	NUMBER OF SHARES	AMOUNT	NUMBER OF SHARES
Balance at January 1, 2004	460,000	$ 5,000	8,889,414
Sale of Common Stock and Warrants in connection with the January 2004 financing			

(net of issuance costs of $423,000)	-	-	-
Change in Value of Warrants	-	-	-
Exercise of Employee Stock Options	-	-	-
Expense recognized in connection with Issuance of Options	-	-	-
Net loss	-	-	-
Balance at December 31, 2004	460,000	$ 5,000	8,889,414
Sale of Series F Preferred Stock ($1,000 per share net of expenses of $249,000)	-	-	-
Shares Of Series D Preferred Stock Converted into Common Stock	-	-	-
Shares Of Series F Preferred Stock Converted into Common Stock	-	-	-
Expense recognized in connection with Issuance of Options	-	-	-
Exercise of Employee Options	-	-	-
Net Loss	-	-	-
Balance at December 31, 2005	460,000	5,000	8,889,414
Conversion of Preferred Stock	(460,000)	(5,000)	(8,889,414)
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	-	$ -	-

	SERIES C PREFERRED STOCK $.01 PAR VALUE		SERIE PREFERRE $.01 PA
	NUMBER OF SHARES	AMOUNT	NUMBER OF SHARES
Balance at January 1, 2004	1,000	$ -	7,136
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of $423,000)	-	-	-
Change in Value of Warrants	-	-	-
Exercise of Employee Stock Options	-	-	-
Expense recognized in connection with Issuance of Options	-	-	-
Net loss	-	-	-
Balance at December 31, 2004	1,000	$ -	7,136
Sale of Series F Preferred Stock ($1,000 per share net of expenses of $249,000)	-	-	-

Shares Of Series D Preferred Stock Converted into Common Stock	-	-	(823)
Shares Of Series F Preferred Stock Converted into Common Stock	-	-	-
Expense recognized in connection with Issuance of Options	-	-	-
Exercise of Employee Options	-	-	-
Net Loss	-	-	-
Balance at December 31, 2005	1,000	-	6,313
Conversion of Preferred Stock	(1,000)	-	(6,313)
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	-	$ -	-

	SERIES E PREFERRED STOCK $.01 PAR VALUE		SERI PREFERR $.01 P
	NUMBER OF SHARES	AMOUNT	NUMBER OF SHARES
Balance at January 1, 2004	1,000	$ -	-
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of $423,000)	-	-	-
Change in Value of Warrants	-	-	-
Exercise of Employee Stock Options	-	-	-
Expense recognized in connection with Issuance of Options	-	-	-
Net loss	-	-	-
Balance at December 31, 2004	1,000	$ -	-
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	-	-	-
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	1,000	-	5,280
Conversion of Preferred Stock	(1,000)	-	(4,709)
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

	COMMON STOCK $.01 PAR VALUE		
	NUMBER OF SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL
Balance at January 1, 2004	12,894,166	$ 129,000	$ 102,392,000
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of $423,000)	1,543,209	15,000	4,562,000
Change in Value of Warrants	-	-	(564,000)
Exercise of Employee Stock Options	804,381	8,000	733,000
Expense recognized in connection with Issuance of Options	-	-	147,000
Net loss	-	-	-
Balance at December 31, 2004	15,241,756	$ 152,000	$ 107,270,000
Sale of Series F Preferred Stock ($1,000 per share net of expenses of $249,000)	-	-	6,751,000
Shares Of Series D Preferred Stock Converted into Common Stock	1,454,645	15,000	(15,000)
Shares Of Series F Preferred Stock Converted into Common Stock	765,481	8,000	(8,000)
Expense recognized in connection with Issuance of Options	-	-	41,000
Exercise of Employee Options	1,597,284	16,000	1,488,000
Net Loss	-	-	-
Balance at December 31, 2005	19,059,166	$ 191,000	$ 115,527,000
Conversion of Preferred Stock	48,545,527	485,000	(391,000)
Stock based compensation			4,454,000
Sale of Common Stock, net of issuance expenses of approximately $2.0 million	60,975,610	610,000	47,420,000
Issuance of Common Stock to Placement Agent	1,000,000	10,000	1,070,000
Warrants Issued to Third-Party	-	-	67,000
Dividends Paid to Related Party Shareholders	-	-	(19,512,000)
Deemed Dividends related to beneficial conversion on Series F Preferred Stock	-	-	3,857,000
Exercise of Employee Options	43,330	-	36,000

Issuance of Restricted Stock	861,221	9,000	(9,000)
Net Loss	-	-	-
Balance at December 31, 2006	130,484,854	$ 1,305,000	$ 152,519,000

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

BLUEFLY, INC.
STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (12,193,000)	$ (3,820,000)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	1,532,000	1,259,000
Loss on disposal of assets	-	-
Non-cash expense related to warrants issued to supplier	153,000	347,000
Change in value of warrants	-	-
Provision for returns	1,636,000	1,233,000
Bad debt expense	643,000	270,000
Reserve for inventory obsolesence	1,000,000	659,000
Stock based compensation	4,454,000	41,000
Warrant issued to consultant	67,000	-
Changes in operating assets and liabilities		
(Increase) decrease in		
Inventories	(8,449,000)	(4,941,000)
Accounts receivable	(1,645,000)	(778,000)
Other current assets	(134,000)	554,000
Prepaid expenses	443,000	(1,020,000)
Other assets	-	(187,000)
(Decrease) increase in:		
Accounts payable	(840,000)	1,472,000
Accrued expenses	1,932,000	(171,000)
Interest payable to related party shareholders	(1,217,000)	559,000
Deferred revenue	1,046,000	87,000
Net cash used in operating activities	(11,572,000)	(4,436,000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash collateral in connection with Rosenthal Pledge Agreement	-	1,250,000
Purchase of property and equipment	(2,148,000)	(2,194,000)
Net cash used in investing activities	(2,148,000)	(944,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from June 2006 financing	48,030,000	-
Net proceeds from June 2005 financing	-	6,751,000

Net proceeds from January 2004 financing	-	-
Net proceeds from exercise of Stock Options	36,000	1,504,000
Payments of capital lease obligation	(54,000)	(152,000)
Dividends paid to related party shareholders	(19,512,000)	
Repayment of related party notes	(4,000,000)	-
Net cash provided by financing activities	24,500,000	8,103,000
Net increase (decrease) in cash and cash equivalents	10,780,000	2,723,000
CASH AND CASH EQUIVALENTS		
Beginning of year	9,408,000	6,685,000
End of year	$ 20,188,000	$ 9,408,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for interest	$ 1,658,000	$ 147,000
Non-cash investing and financing activites		
Deemed dividend related to beneficial conversion feature on Series F Preferred Stock	$ 3,857,000	-
Issuance of Common Stock to placement agent	$ 1,080,000	-
Conversion of Preferred Stock to Common Stock	$ 391,000	-
Equipment acquired under capital lease	$ -	-

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

BLUEFLY, INC.
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2006

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, 2007. The Company may seek additional equity or debt financings to maximize the growth of its business or if anticipated operating results are not achieved.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION

The Company recognizes revenue in accordance with Staff Accounting Bulletin ("SAB 104") 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 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, 2006 and 2005, the allowance for doubtful accounts was $397,000 and $78,000, respectively, and the allowance for sales returns was $5,043,000 and $3,407,000, respectively.

Deferred revenue, which consists primarily of goods shipped to customers but not yet received and customer credits, totaled approximately $2,830,000 and $1,784,000 as of December 31, 2006 and 2005, 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 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, 2006 and 2005, inventories, net consists of the following:

	2006	2005
Inventory on hand	$ 23,150,000	$ 15,811,000
Inventory to be received due to returns	2,094,000	1,864,000
Inventory reserves	(1,055,000)	(782,000)
Total inventories, net	$ 24,189,000	$ 16,893,000

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.

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

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 9. 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 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 year ended December 31, 2006 is $4,454,000.

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

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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 years ended December 31, 2005 and 2004 as if the Company had applied the fair value recognition provisions for stock-based employee compensation of SFAS No. 123, as amended. For the year ended December 31, 2005, and 2004 compensation expense of $30,000 and $17,000, respectively, 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. In addition, for the year ended December 31, 2004, $113,000 in compensation expense was recorded in connection with certain options issued to the Company's former Chief Executive Officer pursuant to his separation agreement. Except for these options, no compensation expense has been recorded for the year ended December 31, 2005 and December 31, 2004 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):

	YEAR ENDED DECEMBER 31,	
	2005	2004
Net loss, as reported	(3,820,000)	$ (3,791,000)
Deduct: total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(2,731,000)	(4,617,000)
Add: Stock-based employee compensation expense included in reported net loss	30,000	130,000
Adjusted for Preferred Stock Dividends	(4,958,000)	(4,275,000)
Pro forma net loss available to common shareholders	(11,479,000)	(12,553,000)
Loss per share		
Basic and diluted, as reported	$ (0.54)	$ (0.55)
Basic and diluted, pro forma	$ (0.71)	$ (0.86)

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				
	2006		2005	2004	EXERCISE PRICES
SECURITY					
Options	5,417,116		8,038,528	9,813,379	$0.69- $16.47
Restricted Stock Awards	10,723,488	(3)	-	-	n/a
Warrants	1,695,893		1,883,393	1,704,945	$0.78 - $3.96
Preferred stock	758,620	(1)	44,516,119	43,323,430	
Convertible Notes(2)	-		-	-	

(1) At December 31, 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) Represents debt issued in connection with the July 2003 financing and October 2003 financing, which is convertible into equity securities of the Company sold in any subsequent round of financing, at the holder's at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing. Until such financing occurs, such debt is not convertible into Common Stock. At December 31, 2005, such debt was not convertible into Common Stock. In June 2006, all of the convertible notes were repaid.

(3) Includes both Restricted Stock and Restricted Stock Units

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. The costs associated with online and print advertising are expensed as incurred, while 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, 2006 and 2005. Production costs related to print and television are capitalized until they are released.

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, 2006, 2005 and 2004, fulfillment expenses totaled $4,409,000, $3,642,000 and $2,914,000, respectively. These amounts are included in selling, marketing and fulfillment expenses in the statement of operations.

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 September 2006, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 157, Fair Value Measurements ("SFAS 157"), which defines fair value, establishes a

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framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. The Company is evaluating the potential effects of adopting SFAS 157, and does not expect the adoption to have a material impact on its financial condition and results of operations.

In September 2006 the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108") which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The adoption of this pronouncement will not have a material impact on the Company's financial statements.

In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires an entity to recognize the impact of a tax position in its financial statements if that position is more likely than not to be sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of fiscal year 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. Early application of FIN 48 is encouraged. The Company is still evaluating the timing of its adoption of FIN 48 and the potential effects of implementing this Interpretation, but does not expect its adoption to have a material effect on its financial condition and results of operations due to the fact the Company has incurred significant losses.

CONCENTRATION

The Company acquired approximately 27.5% and 13.5% of its inventory from one supplier for fiscal 2006 and 2005, 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-basedcompensation. Actual results could differ from those estimates.

3. PROPERTY AND EQUIPMENT

As of December 31, 2006 and 2005, property and equipment consists of the following:

	2006	2005
Leasehold improvements	$ 1,814,000	$ 1,658,000
Office equipment	594,000	574,000
Computer equipment and software	9,101,000	7,129,000
	11,509,000	9,361,000
Less: Accumulated depreciation	(7,936,000)	(6,466,000)
	$ 3,573,000	$ 2,895,000

Depreciation and amortization of property and equipment was approximately $1,419,000, $1,145,000 and $1,331,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

4. PREPAID EXPENSES AND OTHER CURRENT ASSETS

As of December 31, 2006 and 2005, prepaid expenses and other current assets consist of the following:

	2006	2005
Prepaid expenses	$ 341,000	$ 915,000
Prepaid inventory	616,000	485,000
Other current assets	553,000	419,000
	$ 1,510,000	$ 1,819,000

5. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

As of December 31, 2006 and 2005, accrued expenses and other current liabilities consist of the following:

	2006	2005
Salary, vacation and bonus accrual	$ 763,000	$ 574,000
Current portion of capital lease liability	13,000	40,000
Accrued media expenses	667,000	328,000
Other accrued expenses	465,000	141,000
	$ 1,908,000	$ 1,083,000

6. OTHER INCOME

In June 2002, the Company entered into an agreement with a third party investor pursuant to which the investor committed to purchase approximately $7 million of Common Stock and warrants from the Company. The investor breached the contract by failing to consummate the investment, although it did provide the Company with $169,000 as a good faith deposit. In October 2002, the Company filed an action against the investor based on its failure to consummate the investment, and in December 2003, the court entered judgment in the Company's favor against the third party investor in the amount of $3,793,688. In the first quarter of 2004, following the expiration of all

applicable appeal periods, the Company recognized the good faith deposit of $169,000 as other income, as a partial recognition of litigation settlement. Based on the information currently available to it regarding the investor's finances, the Company does not believe that it will be successful in collecting a material amount of additional funds as a result of the damages award.

In addition, as discussed in Note 9, the Company recognized $564,000 of other income for the year ended December 31, 2004 to adjust a liability associated with warrants issued by the Company to its fair value as of June 17, 2004 (at which point the liability was reclassified as equity in accordance with EITF 00-19 and described in Note 9).

7. INCOME TAXES

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

	2006	2005
DEFERRED TAX ASSETS		
Net operating losses	$ 33,437,000	$ 29,252,000

Depreciation and amortization	285,000	(137,000)
Accounts receivable and inventory reserves	587,000	348,000
Other accruals	313,000	528,000
Stock options	(2,201,000)	-
Deferred revenue	-	721,000
Returns reserve	2,038,000	-
	34,459,000	30,712,000
Valuation Allowance	(34,459,000)	(30,712,000)
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 $82,744,000 at December 31, 2006 which have expiration dates from 2018 through 2025. Approximately $6.4 million of these net operating loss carryforwards relate to the exercise of employee stock options. 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 35% as follows:

	2006	2005	2004
Statutory federal income tax rate	(35.00)%	(35.00)%	(35.00)%
State tax benefit, net of federal taxes	(5.41)%	(5.41)%	(5.41)%
Other	2.23%	0.27%	0.34%
Valuation allowance on deferred tax asset	38.18%	40.14%	40.07%
Effective tax rate	0.00%	0.00%	0.00%

8. COMMITMENTS AND CONTINGENCIES

EMPLOYMENT CONTRACTS

During 2006, the Company entered into thirty-six month employment agreements with its Chief Executive Officer ("CEO ") and Chief Financial Officer ("CFO"). These employment agreements along with certain other

employment agreements, have terms expiring through July 2009. As of December 31, 2006, the Company's aggregate cash commitment for future base salary under these employment contracts is:

2007	$ 1,990,000
2008	1,363,000
2009	425,000
	$ 3,778,000

LEASES

The Company leases equipment and space under various capital and operating leases that expire at various dates through 2011. Future minimum lease payments under capital and operating leases, excluding utilities, that have initial or remaining non-cancelable terms in excess of one year are as follows:

Rent expense (including amounts related to commercial rent tax) aggregated approximately $566,000, $450,000 and $442,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

MARKETING AND TECHNOLOGY COMMITMENTS

As of December 31, 2006, 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 $1,068,000 through December 31, 2007.

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 will develop an improved version of its Web site based

on the new software. The new version of Bluefly's Web site is expected to launch in the third quarter of 2007 and will replace the older version. In connection with this Master License Agreement, the Company has committed to spend $1,207,000, of which $999,000 was incurred during the fourth quarter of 2006 and the balance of $208,000 will be paid during 2007.

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.

9. SHAREHOLDERS' EQUITY

AUTHORIZED SHARES

The Company is incorporated in Delaware and has 152,000,000 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

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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 are being 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

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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.

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.

JANUARY 2004 FINANCING

In January 2004, the Company completed a private placement pursuant to which it raised $5,000,000 (the "January 2004 Financing"). Under the terms of the deal, the Company issued 1,543,209 shares of Common Stock at $3.24 per share, which was 90% of the trailing five-day average of the Company's volume-weighted stock price as of December 29, 2003, the date that a preliminary agreement was reached as to the pricing of the deal. The Company also issued to the new investors warrants to purchase 385,801 shares of Common Stock at any time during the next five years at an exercise price equal to $3.96 per share. After professional fees and finders fees paid to brokers, the net proceeds from the transaction were approximately $4,577,000.

WARRANTS TO PURCHASE COMMON STOCK
WARRANTS TO SOROS

The Company has issued warrants to Soros in connection with past and recent financings as well as in connection with the Rosenthal 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 11.

In connection with the January 2003 Financing, the Company issued warrants to purchase 25,000 shares of its common stock, exercisable at any time on or prior to January 28, 2007 at $1.12 per share to Soros. Subsequent to year end the warrants were exercised.

The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 3.54%, volatility 113%, expected life 4 years, zero dividend yield. Using these factors the warrants were valued at $21,000 and were expensed over the life of the note. The full amount was expensed in the first quarter of 2003.

In exchange for the March 2002 Standby Agreement, the Company issued to Soros warrants to purchase 100,000 shares of Common Stock at an exercise price of $1.68 per share (the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance), exercisable at any time until March 27, 2007. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 5.22%, volatility 183%, expected life 3 years, zero dividend yield. The Company accounted for the warrants by crediting additional paid in capital for approximately $157,000 and capitalizing the amount on the balance sheet. This amount was then netted against the proceeds from the subsequent May 2003 Financing and July 2003 Financing described above, on a pro rata basis.

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.

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.

In accordance with EITF 00-19, the Company accounted for the 385,801 warrants issued in connection with the January 2004 Financing at fair market value and classified the warrants as a liability because the Company

may have been required to make cash payments to the investors who purchased the warrants in the event that the registration statement covering the offer and sale of the shares underlying the warrants were to no longer be effective. The Company used the Black-Scholes option pricing method (assumption: volatility 147%, risk free rate 3.76% two year expected life and zero dividend yield) to calculate the value of the warrants. At January 12, 2004, the date of transaction (the "Transaction Date"), the warrants had a value of $1,096,000. The value of the warrants was marked to market in each subsequent reporting period as a derivative gain or loss until June 17, 2004 (the "End Date"), at which time EITF 00-19 called for the warrants to be re-classified as equity because the maximum potential cash amount payable to the investors had decreased to the point where it was no longer considered significant.

During the period beginning on the Transaction Date and ending on the End Date, the value of the warrants decreased from $1,096,000 to $532,000, and, accordingly the Company recognized $564,000 of other income for the year ended December 31, 2004.

The following table represents warrants issued to purchase Common Stock as of December 31, 2006:

PARTY	NUMBER OF WARRANTS	EXERCISE PRICE RANGE	EXPIRATION DATES
Investors	989,249	$2.87 - $3.96	June 2008 - January 2009
Soros	606,644	$0.78 - $2.34	January 2007 - March 2013
Consultant	100,000	$1.00	February 2011
	1,695,893		

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 CEO and 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.

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 will recognize an expense of $9.3 million over three years. Approximately $2.1 million of this expense was recognized in 2006.

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, 2006:

	RESTRICTED STOCK	DEFERRED STOCK UNIT AWARDS
Balance at January 1, 2006	--	--
Shares/Units Granted	861,221	9,862,267
Shares/Units Forfeited	--	--
Balance at December 31, 2006	861,221	9,862,267
Weighted Average Grant Date Fair Value Per share	$0.95	$0.94
Aggregate Grant Date Fair Value	$818,160	$9,270,531
Vesting Service Period of Shares Granted	3 months	12 - 36 months
Number of shares/units vested at December 31, 2006	--	--
Number of shares/units unvested at December 31, 2006	861,221	9,862,267

For the year ended December 31, 2006 the Company recognized an expense of approximately $2,159,000 in connection with these awards.

As of December 31, 2006 the total compensation cost related to non-vested restricted stock and deferred stock units not yet recognized was $8.3 million. Total compensation cost is expected to be recognized over a three year period beginning on October 1, 2006.

STOCK OPTIONS

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

	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Balance at January 1, 2004	8,508,370	$ 2.04
Options granted	2,629,750	$ 2.74
Options canceled	(534,360)	$ 2.57
Options exercised	(790,381)	$ 0.95
Balance at December 31, 2004	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
Vested at December 31, 2004	6,512,125	$ 2.44
Vested at December 31, 2005	4,969,929	$ 2.15
Vested at December 31, 2006	3,682,877	$ 1.83

The stock options are exercisable in different periods through 2016. Additional information with respect to the outstanding options as of December 31, 2006, is as follows:

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
$0.00 - $1.66	3,985,116	7.2 Years	$1.09	2,645,881	$1.06
$1.66 - $3.32	1,192,500	7.2 Years	$2.30	819,091	$2.43
$3.32 - $4.98	75,000	7.1 Years	$3.92	53,405	$3.92
$4.98 - $6.64	22,250	2.0 Years	$5.11	22,250	$5.11
$6.64 - $9.96	52,750	2.6 Years	$9.17	52,750	$9.17
$9.96 - $11.62	54,250	3.0 Years	$11.18	54,250	$11.18

$11.62 - $14.94	6,250	2.9 Years	$14.04	6,250	$14.04
$14.94 - $16.60	29,000	2.1 Years	$15.19	29,000	$15.19
$0.69 - $16.60	5,417,116	7.0 YEARS	$1.68	3,682,877	$1.83

The total fair value of the 1,427,008 options that vested during the year was approximately $2,198,000. At December 31, 2006, the aggregate intrinsic value of the fully vested options was $683,000 and the weighted average remaining contractual life of the options was 6.2 years. The Company has not capitalized any compensation cost, or modified any of its stock option grants for the years ended December 31, 2006 and 2005. Other selected information is as follows:

	2006	2005	2004
Aggregate intrinsic value of outstanding options	$ 881,000	$ 399,000	$ 6,573,000
Aggregate intrinsic value of options exercised	$ 7,000	$ 1,088,000	$ 1,210,000
Weighted average fair value of options granted	$ 0.79	$ 1.24	$ 2.60

As of December 31, 2006 the total compensation cost related to non-vested stock option awards not yet recognized was $2,252,000. Total compensation cost is expected to be recognized over 1.5 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 CEO and 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, 2006, 2005 and 2004 respectively:

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Risk-free interest rates	4.65%	4.22%	3.63%

Expected life (in years)	6	6	6
Dividend yield	0%	0%	0%
Expected volatility	101%	138%	139%

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 15.

10. NOTES PAYABLE TO RELATED PARTY SHAREHOLDERS

In connection with the June 2006 Financing described above, 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.

In addition to the $4,000,000 of promissory notes issued in connection with the July 2003 Financing and October 2003 Financing (see Note 9), on December 15, 2001, the Company issued promissory notes in the amount of $182,000 to affiliates of Soros in exchange for legal services provided during the course of the year. The notes bore interest at 9% per annum and had a maturity date of December 15, 2004. In December 2004 the Company repaid the notes with accrued interest of $54,000 for a total of $236,000.

11. 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 has also been 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). In return, the Company, agreed to maintain a minimum cash balance of $5,000,000. Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. 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, 2006, total availability under the Credit Facility, was approximately $7,500,000 of which $3,200,000 was committed, leaving approximately $4,300,000 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%. 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%. We also pay 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, 2006, 2005 and 2004 total interest expense and fees related to the credit facilities totaled approximately $170,000, $196,000 and $112,000, respectively.

Under the terms of the Credit Facility, Soros has the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

SOROS WARRANTS IN CONNECTION WITH ROSENTHAL LOAN FACILITY

Prior to April 2004, Soros guaranteed repayment of the Rosenthal 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	Reason
100,000	March 31, 2001	$0.88(1)	September 11, 2011	Risk Free Rate - 4.86% Volatility - 117% Term - 5 years	As consideration for Soros establishing the Soros Guarantee
60,000	March 22, 2002	$1.66(1)	March 22, 2007	Risk Free Rate - 5.25% Volatility - 184% Term - 3 years	In consideration for Soros extending the Soros Guarantee until 11/15/2003
25,000	March 17, 2003	$0.78(2)	March 17, 2013	Risk Free Rate - 3.31% Volatility - 123% Term - 4 years	In consideration for Soros extending the Soros Guarantee until 11/15/2004

(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 for $74,000, $98,000 and $21,000, during the years 2001, 2002 and 2003, respectively. These amounts were amortized to interest expense over the life of the Loan Facility.

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12. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Amounts in thousands, except per share data:

	QUARTER ENDED			
2006	MARCH 31	JUNE 30	SEPTEMBER 30	DECE
Net Sales	$ 16,876	$ 16,793	$ 16,322	$
Gross Profit	$ 6,839	$ 7,046	$ 6,111	$
Net Loss (1)	$ (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 (2)	$ (0.22)	$ (0.17)	$ (0.03)	$

	QUARTER ENDED			
2005	MARCH 31	JUNE 30	SEPTEMBER 30	DECE
Net Sales	$ 13,502	$ 12,029	$ 12,045	$
Gross Profit	$ 4,885	$ 4,651	$ 4,575	$
Net loss	$ (893)	$ (1,169)	$ (1,703)	$
Preferred stock dividends	$ (1,115)	$ (1,169)	$ (1,387)	$
Net loss available to common shareholders	$ (2,008)	$ (2,338)	$ (3,090)	$
Loss per common share - basic and diluted	$ (0.13)	$ (0.15)	$ (0.20)	$

(1) Included in net loss is a non-cash charge of approximately $4.5 million for the year ended December 31, 2006 to stock-based compensation recorded in accordance with SFAS No. 123(R), this amount was recorded as follows: $612, $611, $597 and $2.6 million in the first, second, third and fourth quarter, respectively

(2) 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.

13. RELATED PARTY TRANSACTION

In August 2004, the Company entered into a Separation Agreement with its former Chief Executive Officer in connection with his resignation. Under the terms of the agreement, he agreed to remain employed by the Company in a non-executive capacity through November 30, 2004 (the "Termination Date") at his then-current salary and to extend the period of the non-competition and non-solicitation covenants contained in his employment agreement from one year to two years after the Termination Date. In consideration for these agreements, the Company, among other things, agreed to (i) to make salary continuation payments equal to his salary until June 30, 2005, (ii) to continue to provide his then-current employee benefits for a period of one year following the Termination Date, and (iii) to issue him an option to purchase 100,000 shares of Common Stock at an exercise price equal to the fair market value of the Common Stock on the date of grant and (iv) that all outstanding stock options held by him would vest upon the Termination Date. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 3.88%, volatility 137%, expected life 1 year, zero dividend

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yield, and charged $113,000 for the options and $212,000 related to severance and benefits to general and administrative expense in the third quarter of 2004.

14. NASDAQ COMPLIANCE

In November 9, 2006, the Company was notified by Nasdaq Staff that it was not in compliance with the continued listing requirements for the Nasdaq Capital Market (the "Listing Requirements") 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. On December 21, 2006, the Company was advised by Nasdaq that, because the closing bid price of the Company's common stock has been at $1.00 per share or greater for at least 10 consecutive trading days, the Company has regained compliance with the Listing Requirements.

15. SUBSEQUENT EVENTS

In January 2007, the Company commenced an exchange offer (the "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.

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 has instituted the exchange offer because a considerable number of its employees are holding options that have exercise prices higher than

the current and recent trading prices of its common stock. The purpose of the exchange offer is 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 will account for the exchange of Options for restricted stock and deferred stock unit awards as replacement awards in accordance with SFAS No. 123(R).

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SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
FOR THE THREE YEARS ENDED DECEMBER 31, 2006

Column A	Column B	Column C (1)	Column C (2)	Column
Description	Beginning Balance at January 1, 2006	Charged to Costs and Expenses	Charged to other Accounts	Deductio
Allowance for Sales Returns	(3,407,000)	(50,126,000)	--	48,490,
Allowance for Doubtful Accounts	(78,000)	(643,000)	--	324,
Inventory Reserves	(782,000)	(1,000,000)	--	727,
Deferred Tax Valuation Allowance	(30,712,000)	(4,656,000)	909,000	

Column A	Column B	Column C (1)	Column C (2)	Column
Description	Beginning Balance at January 1, 2005	Charged to Costs and Expenses	Charged to other Accounts	Deductio
Allowance for Sales Returns	(2,174,000)	(34,820,000)	-	33,587,
Allowance for Doubtful Accounts	(44,000)	(270,000)	-	236,
Inventory Reserves	(835,000)	(659,000)	-	712,
Deferred Tax Valuation				

Allowance	(28,738,000)	(1,533,000)	(441,000)	

Column A	Column B	Column C (1)	Column C (2)	Column
Description	Beginning Balance at January 1, 2004	Charged to Costs and Expenses	Charged to other Accounts	Deductio
Allowance for Sales Returns	(2,528,000)	(24,186,000)	-	24,540,
Allowance for Doubtful Accounts	(40,000)	(237,000)	-	233,
Inventory Reserves	(673,000)	(100,000)	-	(62,
Deferred Tax Valuation Allowance	(26,872,000)	(1,518,000)	(348,000)	

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