PFSWEB INC
Form 10-Q
August 14, 2006

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

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

For the Quarterly Period Ended June 30, 2006

OR

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

For the Transition Period from __________ to __________

Commission File Number 000-28275

PFSweb, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-2837058**
(State of Incorporation)	(I.R.S. Employer I.D. No.)
500 North Central Expressway, Plano, Texas	7**5074**
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by 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 o Accelerated filer o Non-accelerated filer þ

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

At August 8, 2006 there were 46,451,443 shares of registrant s common stock outstanding, excluding 86,300 shares of common stock in treasury.

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PART I. FINANCIAL INFORMATION
ITEM 1. Financial Statements

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

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 17,553	$ 13,683
Restricted cash	1,406	2,077
Accounts receivable, net of allowance for doubtful accounts of $1,875 and $484 at June 30, 2006 and December 31, 2005, respectively	48,538	44,556
Inventories, net	57,519	43,654
Other receivables	9,816	9,866
Prepaid expenses and other current assets	3,223	3,213
Total current assets	138,055	117,049
PROPERTY AND EQUIPMENT, net	13,525	13,040
RESTRICTED CASH		150
IDENTIFIABLE INTANGIBLES	7,316	
GOODWILL	18,545	
OTHER ASSETS	836	1,487
Total assets	$ 178,277	$ 131,726
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 27,709	$ 21,626
Trade accounts payable	70,718	60,053
Accrued expenses	18,667	12,011
Total current liabilities	117,094	93,690
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current Portion	1,892	6,289
OTHER LIABILITIES	1,432	1,813
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		

Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued and outstanding		
Common stock, $0.001 par value; 75,000,000 shares authorized; 46,526,100 and 22,613,314 shares issued at June 30, 2006 and December 31, 2005, respectively; and 46,439,800 and 22,527,014 outstanding at June 30, 2006 and December 31, 2005, respectively	47	23
Additional paid-in capital	90,858	58,736
Accumulated deficit	(34,595)	(29,824)
Accumulated other comprehensive income	1,634	1,084
Treasury stock at cost, 86,300 shares	(85)	(85)
Total shareholders equity	57,859	29,934
Total liabilities and shareholders equity	$ 178,277	$ 131,726

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
REVENUES:				
Product revenue, net	$ 89,650	$ 63,438	$ 179,854	$ 127,068
Service fee revenue	16,209	16,298	32,128	30,383
Pass-through revenue	3,445	5,134	7,990	9,284
Total net revenues	109,304	84,870	219,972	166,735
COSTS OF REVENUES:				
Cost of product revenue	84,486	59,613	168,809	119,250
Cost of service fee revenue	11,366	12,102	22,745	22,870
Pass-through cost of revenue	3,445	5,134	7,990	9,284
Total costs of revenues	99,297	76,849	199,544	151,404
Gross profit	10,007	8,021	20,428	15,331
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	12,531	7,952	23,892	14,918
Income (loss) from operations	(2,524)	69	(3,464)	413
INTEREST EXPENSE, NET	517	474	948	793
Loss before income taxes	(3,041)	(405)	(4,412)	(380)
INCOME TAX EXPENSE	143	141	359	380
NET LOSS	$ (3,184)	$ (546)	$ (4,771)	$ (760)
NET LOSS PER SHARE:				
Basic and Diluted	$ (0.07)	$ (0.02)	$ (0.12)	$ (0.03)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic and Diluted	43,072	22,419	39,011	22,278

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

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,771)	$ (760)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,589	3,012
Loss on disposal of assets	143	
Provision for doubtful accounts	275	(68)
Provision for excess and obsolete inventory	452	
Deferred income taxes	(24)	30
Stock option expense	480	14
Changes in operating assets and liabilities:		
Restricted cash	879	
Accounts receivables	2,216	(2,948)
Inventories, net	(6,217)	(3,228)
Prepaid expenses, other receivables and other assets	975	237
Accounts payable, accrued expenses and other liabilities	3,030	(2,623)
Net cash provided by (used in) operating activities	1,027	(6,334)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,123)	(2,561)
Payment for purchase of eCOST, net of cash acquired	(1,299)	
Decrease in restricted cash	748	1,348
Net cash used in investing activities	(2,674)	(1,213)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on capital lease obligations	(692)	(580)
Decrease in restricted cash	247	837
Proceeds from issuance of common stock	4,888	1,940
Proceeds from debt, net	1,210	5,144
Net cash provided by financing activities	5,653	7,341
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(136)	53
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,870	(153)
CASH AND CASH EQUIVALENTS, beginning of period	13,683	13,592

CASH AND CASH EQUIVALENTS, end of period	$ 17,553	$ 13,439
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under capital leases	$ 708	$ 891

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

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

1. OVERVIEW AND BASIS OF PRESENTATION

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

PFSweb Overview

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

Supplies Distributors Overview

Supplies Distributors acts as a master distributor of various products, primarily International Business Machines Corporation (IBM) product, under a master distributor agreement with IBM. Supplies Distributors has outsourced to PFSweb the transaction management and fulfillment service functions of its distribution business and has outsourced to a third party the sales and marketing functions. Supplies Distributors sells its products in the United States, Canada and Europe.

eCOST Overview

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

Acquisition of eCOST

Effective February 1, 2006, a wholly-owned subsidiary of PFSweb merged with and into eCOST, with eCOST surviving the merger as a wholly-owned subsidiary of PFSweb. Each of the 18,858,132 issued and outstanding shares of common stock of eCOST were converted into one share of common stock of the Company. In conjunction with the merger, PFSweb assumed 36,210 warrants previously issued to a former eCOST warrantholder with an exercise price of $2.00 per share, subject to the terms set forth therein. As a result of the merger, effective February 1, 2006, PFSweb began consolidating 100% of eCOST s financial position and results of operations into PFSweb s consolidated financial statements. The following table presents selected pro forma information, for comparative purposes, assuming the acquisition had occurred on January 1 for the periods presented (unaudited) (in thousands):

	Three Months Ended		Six Months Ended	
	2006	2005	2006	2005
Net revenues	$109,304	$125,918	$232,906	$262,839
Net loss	(3,184)	(3,665)	(6,361)	(6,908)
Basic and diluted loss per share	(.07)	(.09)	(.16)	(.17)

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PFSweb, Inc. and Subsidiaries
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The unaudited pro forma information combines the historical unaudited consolidated statements of the Company s operations and eCOST s operations for the three and six months ended June 30, 2006 and 2005 giving effect to the merger and related events as if they had been consummated on January 1 for the periods presented. Pro forma adjustments have been made to reflect the amortization expense relating to the finite lives of certain acquired intangibles, such as trademark name and customer relationships and the reversal of the income tax expense recognized by eCOST in the three and six months ended June 30, 2005.

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

The transaction was accounted for using the purchase method of accounting for business combinations and, accordingly, the results of operations of eCOST have been included in the Company s consolidated financial statements since the date of acquisition. For purposes of computing the purchase price, the value of the 18.9 million shares of PFSweb common stock issued was $1.42 per common share, based on the average closing price of PFSweb s common stock on NASDAQ for the period beginning two days prior to the consummation of the merger and ending on the consummation of the merger. The following table summarizes the preliminary unaudited, estimated fair value of the assets acquired and liabilities assumed as of February 1, 2006. The Company is in the process of finalizing the purchase price allocation and, accordingly, the allocation of the purchase price is subject to adjustment (in thousands):

Cash and restricted cash	$ 1,053
Accounts receivable, net	5,767
Inventories	6,898
Identifiable intangibles	7,657
Property and equipment	700
Other assets	322
Total assets acquired	22,397
Trade accounts payable	8,804
Accrued expenses	3,267
Other liabilities	793
Total liabilities assumed	12,864
Net assets acquired	9,533
Estimated purchase price	28,078
Goodwill acquired	$ 18,545

Estimated purchase price for eCOST is as follows (in thousands):

Number of shares of common stock issued	18,858
Multiplied by PFSweb s stock price	$ 1.42
Share consideration	$ 26,778

Estimated transaction costs	1,300
Estimated purchase price	$ 28,078

The above purchase price has been preliminarily allocated based on estimates of the fair values of assets acquired and liabilities assumed. The final valuation of net assets is expected to be completed as soon as possible, but no later than one year from the acquisition date.

The excess of the purchase price over the fair value of the net assets acquired and liabilities assumed was allocated to goodwill. The total goodwill of $18.5 million, none of which is deductible for tax purposes, is not being amortized but is subject to an impairment test each year using a fair-value-based

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

approach pursuant to SFAS No. 142. The Company is amortizing the identifiable intangible assets acquired on a straight-line basis over their estimated remaining useful lives.

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of June 30, 2006, and for the three and six months ended June 30, 2006 and 2005, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim condensed consolidated financial statements of the Company include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the Company s financial position as of June 30, 2006, its results of operations for the three and six months ended June 30, 2006 and 2005 and its results of cash flows for the six months ended June 30, 2006 and 2005. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Revenue Recognition

Net sales include product sales, gross outbound shipping charges, and related handling fees, and to a lesser extent, third-party extended warranties and other services. eCOST recognizes revenue from product sales, net of estimated returns, promotional discounts, credit card fraud and chargebacks, and coupon redemptions, when both title and risk of loss to the products has transferred to the customer, which eCOST has determined to occur upon receipt of products by the customer. eCOST generally requires payment by credit card upon placing an order, and to a lesser extent, grants credit to business customers on normal credit terms.

eCOST periodically provides incentive offers to customers including percentage discounts off current purchases. Such discounts are recorded as a reduction of the related purchase price at the time of sale based on actual and estimated redemption rates. Future redemption rates are estimated using eCOST s historical experience for similar sales inducement offers.

For product sales shipped directly from eCOST s vendors to end customers, eCOST records revenue and related costs at the gross amounts charged to the customer and paid to the vendor based on an evaluation of the criteria outlined in EITF No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*. eCOST s evaluation is performed based on a number factors, including whether eCOST is the primary obligor in the transaction, has latitude in establishing prices and selecting suppliers, takes title to the products sold upon shipment, bears credit risk, and bears inventory risk for returned products that are

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PFSweb, Inc. and Subsidiaries
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not successfully returned to third-party suppliers. eCOST recognizes revenue on extended warranties and other services for which it is not the primary obligor on a net basis.

Investment in Affiliates

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has loaned Supplies Distributors and eCOST $6.5 million and $3.5 million, respectively, as of June 30, 2006, which are eliminated in consolidation. Under the terms of certain of the Company s debt facilities, the outstanding balance of the Supplies Distributors loan cannot be increased to more than $8.0 million or decreased to less than $6.5 million without prior approval of the Company s lenders and the outstanding balance of the eCOST loan amount cannot be less than $2.0 million without prior approval of eCOST s lender or increased above $3.5 million without the approval of PFS lender. Additionally, PFSweb loaned eCOST $2.5 million during the second quarter of 2006, which remained outstanding as of June 30, 2006.

Concentration of Business and Credit Risk

Supplies Distributors product revenue was primarily generated by sales to customers of product purchased under master distributor agreements with one supplier. The Company s service fee revenue is generated under contractual service fee relationships with multiple client relationships. There were no clients or customers that exceeded 10% of consolidated revenue during the 2006 or 2005 periods. A summary of the customer and client concentrations is as follows:

	Six Months Ended	
	June 30, 2006	**June 30, 2005**
Product Revenue (as a percentage of Product Revenue):		
Customer 1	11%	13%
Customer 2	9%	11%
Customer 3	8%	11%
Service Fee Revenue (as a percentage of Service Fee Revenue):		
Client 1	25%	32%
Client 2	19%	14%
Client 3	12%	12%
Accounts Receivable:		
1 Customer	13%	13%

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

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

eCOST s arrangements with its vendors are terminable by either party at will. Loss of any vendors could have a material adverse effect on its financial position, results of operations and cash flows. Sales of HP and HP-related products represented 31% of eCOST s net revenues, or 7% of consolidated net revenues, in

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the six months ended June 30, 2006.

Cash and Cash Equivalents

Cash equivalents are defined as short-term highly liquid investments with original maturities of three months or less.

Accounts Receivable

Accounts receivable consist primarily of amounts due from customers/clients to whom the Company has extended credit as well as amounts due from vendors related to co-op advertising costs. The Company records vendor receivables at such time as all conditions have been met that would entitle the Company to receive such vendor funding and is thereby considered fully earned.

The Company maintains an allowance for doubtful accounts receivable based upon estimates of future collection. The Company regularly evaluates customers financial condition and credit history in determining the adequacy of the allowance for doubtful accounts. The Company also maintains an allowance for uncollectible vendor receivables, which arise from vendor rebate programs, price protections and other promotions. The Company determines the sufficiency of the vendor receivable allowance based upon various factors, including payment history. If estimated allowances for uncollectible accounts or vendor receivables subsequently prove insufficient, additional allowances may be required.

Inventories

Inventories (all of which are finished goods) are stated at the lower of weighted average cost or market. The Company establishes inventory reserves based upon estimates of potential declines in values due to inventories that are potentially slow moving or obsolete, potential excess levels of inventory or values assessed at potentially lower than cost.

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

Supplies Distributors inventories include merchandise in-transit that has not been received by the Company but that has been shipped and invoiced by Supplies Distributors vendors. The corresponding payable for inventories in-transit is included in accounts payable in the accompanying consolidated financial statements.

eCOST inventories include goods in-transit to customers.

The allowance for slow moving inventory was $1.9 million and $1.5 million at June 30, 2006 and December 31, 2005, respectively.

Property and Equipment

The Company s property held under capital leases amounted to approximately $3.4 million and $3.3 million, net of accumulated amortization of approximately $9.0 million and $8.3 million, at June 30, 2006 and December 31, 2005, respectively.

Advertising Costs

eCOST produces and circulates catalogs at various dates throughout the year and receives market development funds and co-op advertising funds from vendors included in each catalog. Pursuant to

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Statement of Position (SOP) 93-7, *Reporting on Advertising Costs*, the costs of developing, producing and circulating each catalog are deferred and charged to advertising expense ratably over the life of the catalog based on the revenue generated from each catalog, approximately eight weeks. Advertising expenses for eCOST, including those for catalog, internet and other methods, were $1.9 million for the period from the eCOST acquisition date through June 30, 2006 and are included in selling, general and administrative expenses. There were no such expenses to the Company prior to the acquisition of eCOST.

Market development and co-op advertising funds pursuant to Emerging Issues Task Force (EITF) 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received form a Vendor*, are recognized as an offset to cost of goods sold. Direct market development and co-op funds for eCOST were $1.1 million for the period from the acquisition date through June 30, 2006. There were no such funds recognized by the Company prior to the acquisition of eCOST.

Intangible Assets

Intangible assets acquired consisted of the following as of June 30, 2006 (in thousands):

	Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	8 years	$ 2,072	$ (108)	$ 1,964
Trademark/Domain name	10 years	5,585	(233)	5,352
Total intangible assets		$ 7,657	$ (341)	$ 7,316

3. *__COMPREHENSIVE LOSS (in thousands)__*

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Net loss	$ (3,184)	$ (546)	$ (4,771)	$ (760)
Other comprehensive loss:				
Foreign currency translation adjustment	348	(544)	551	(1,087)
Comprehensive loss	$ (2,836)	$ (1,090)	$ (4,220)	$ (1,847)

4. *__NET LOSS PER COMMON SHARE__*

Basic and diluted net loss per share is computed by dividing net loss available to common shareholders by the weighted-average number of common shares outstanding for the reporting period. For the three months ended June 30, 2006 and 2005 and the six months ended June 30, 2006 and 2005, outstanding options of 6.1 million, 5.5 million, 6.1 million and 5.5 million, respectively, to purchase common shares were anti-dilutive and have been excluded from the weighted diluted average share computation. Warrants not included in the calculation of diluted net loss per share for the three and six months ended June 30, 2006 were 601,190 and for the three and six months ended June 30, 2005 were 395,486 as the effect would be anti-dilutive. Outstanding warrants have been adjusted to give effect to the recent merger with eCOST and the sale by the Company of 5,000,000 shares of common stock on June 1, 2006 in a private placement transaction.

5. *__STOCK AND STOCK OPTIONS__*

Private Placement Transaction

In June 2006, the Company entered into a Purchase Agreement and Registration Rights Agreement with certain institutional investors in a private placement transaction pursuant to which the Company issued and sold an aggregate of 5,000,000 shares of its common stock, par value $.001 per share (the Common Stock), at $1.00 per share, resulting in gross proceeds of $5.0 million. After deducting expenses, the net proceeds were approximately $4.8 million.

Stock Options and Stock Option Plans

On January 1, 2006, the Company adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (FAS 123R). Prior to January 1, 2006, the Company accounted for share-based employee compensation plans using the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations. In accordance with APB 25 no compensation was required to be recognized for options granted that had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant.

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The Company adopted FAS 123R using the modified prospective transition method. Under that transition method, compensation cost recognized during the three and six months ended June 30, 2006 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of FAS 123R. Compensation cost is recognized on a straight-line basis, net of estimated forfeitures, over the requisite service period of each award. Results for prior periods have not been restated.

As a result of adoption FAS 123R, stock compensation expense charged against income was $0.2 million and $0.5 million for the three and six months ended June 30, 2006, respectively, which is included in selling, general and administrative expenses. As of June 30, 2006, there was $1.6 million of total unrecognized compensation costs related to unvested stock options, which is expected to be recognized over a weighted average period of approximately 1.3 years.

The following table illustrates the effect on net loss and net loss per share for the three and six months ended June 30, 2005 as if our stock-based compensation had been determined based on the fair value at the grant date (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss as reported	$ (546)	$ (760)
Add: Stock-based non-employee compensation expense included in reported net loss	14	14
Deduct: Total stock-based employee and non-employee compensation expense determined under fair value based method	(373)	(575)
Pro forma net loss, applicable to common stock for basic and diluted computations	$ (905)	$ (1,321)
Loss per common share as reported Basic and diluted	$ (0.02)	$ (0.03)
Loss per common share pro forma Basic and diluted	$ (0.04)	$ (0.06)

As of June 30, 2006, the Company has the following share-based compensation plans:

PFSweb Plan Options

The Company has an Employee Stock and Incentive Plan and an Outside Director Stock Option and Retainer Plan under which an aggregate of 8,500,000 shares of common stock were originally authorized for issuance (the Stock Options Plans) and an outstanding stock option agreement under which 35,000 shares were originally authorized for issuance. The Stock Option Plans provide for the granting of incentive awards in the form of stock options to directors, executive management, key employees, and outside consultants of the Company. The rights to purchase shares under the employee stock option agreements typically vest over a three-year period, one-twelfth each quarter. Stock options must be exercised within 10 years from the date of grant. Stock options are generally issued such that the exercise price is equal to the fair market value of the Company s common stock at the date of grant.

As of June 30, 2006, there were 2,174,516 shares available for future options under the Stock Option Plans.

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The following table summarizes stock option activity under the Stock Option Plans:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding, December 31, 2005	4,947,950	$ 1.30	6.8	
Granted	750,000	$ 1.46		
Exercised				
Canceled	(14,250)	$ 2.23		
Outstanding, March 31, 2006	5,683,700	$ 1.32	7.0	$1,321,933
Granted	88,500	$ 1.08		
Exercised	(19,918)	$ 0.40		
Canceled	(52,750)	$ 1.84		
Outstanding, June 30, 2006	5,699,532	$ 1.32	6.7	$ 666,671
Exercisable, June 30, 2006	4,430,423	$ 1.19	6.1	$ 665,761

The weighted average fair value per share of options granted during the three and six months ended June 30, 2006 was $0.87 and $1.27, respectively. The weighted average fair value per share of options granted during the three and six months ended June 30, 2005 was $2.08 and $2.07, respectively. The total intrinsic value of options exercised under the Stock Option Plans during the three and six months ended June 30, 2005 was $0.1 million and $0.2 million, respectively. Of the options granted during 2006, 750,000 of the options were granted to officers and key employees of eCOST in conjunction with the acquisition.

The following table summarizes information concerning currently outstanding and exercisable stock options issued under the Stock Option Plans as of June 30, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding as of June 30, 2006	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable as of June 30, 2006	Weighted Average Exercise Price
$0.39-$0.99	2,925,427	5.8	$ 0.78	2,892,760	$ 0.78
$1.13-$1.92	2,104,855	7.5	$ 1.63	1,229,579	$ 1.74
$2.05-$2.96	661,500	8.5	$ 2.58	300,334	$ 2.58
$10.45-$16.00	7,750	3.1	$ 11.17	7,750	$ 11.17
	5,699,532	6.7	$ 1.32	4,430,423	$ 1.19

PFSweb Non-plan Options

Prior to the Company s initial public offering, certain of the Company s employees were holders of stock options of the Company s former parent company, Daisytek International Corporation (Daisytek), issued under Daisytek s stock option plans.

In connection with the completion of the Company s spin-off from Daisytek on July 6, 2000 (the Spin-off), all outstanding Daisytek stock options were replaced with substitute stock options. Daisytek options held by PFSweb employees were replaced (at the option holder s election made prior to the Spin-off) with either options to acquire shares of PFSweb common stock or options to acquire shares of both Daisytek common stock and PFSweb common stock (which may be exercised separately) (the Unstapled Options). Options held by Daisytek employees were replaced (at the option holder s election made prior to the Spin-off) with either options to acquire shares of Daisytek common stock or Unstapled Options.

As a result of the stock option replacement process described above, in conjunction with the Spin-off, PFSweb stock options (the Non-plan Options) were issued to PFSweb and Daisytek officers, directors and employees. These options were issued as one-time grants and were not issued under the Stock Option Plans. The terms and provisions of the Non-plan Options are substantially the same as options issued under the Stock Option Plans.

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As of June 30, 2006, 434,612 Non-plan Options were outstanding, all of which were held by PFSweb officers, directors and employees.

The following table summarizes stock option activity under the Non-plan Options:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding, December 31, 2005	439,235	$ 0.95	5.9	
Granted				
Exercised				
Canceled				
Outstanding, March 31, 2006	439,235	$ 0.95	5.7	$ 139,842
Granted				
Exercised	(4,623)			
Canceled				
Outstanding, June 30, 2006	434,612	$ 0.95	5.4	$ 43,238
Exercisable, June 30, 2006	434,612	$ 0.95	5.4	$ 43,238

The following table summarizes information concerning Non-plan Options outstanding and exercisable as of June 30, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding as of June 30, 2006	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable as of June 30, 2006	Weighted Average Exercise Price
$0.91	432,382	5.4	$ 0.91	432,382	$ 0.91
$5.78-$10.58	2,230	1.5	$ 8.83	2,230	$ 8.83
	434,612	5.4	$ 0.95	434,612	$ 0.95

Fair Value

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants of options under the Stock Option Plans for the periods indicated:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Expected dividend yield				
Expected stock price volatility	98% - 101%	98% - 102%	105%	105%

Risk-free interest rate	4.9% - 5.2%	4.5% - 5.2%	3.6% - 4.2%	3.6% - 4.6%
Expected life of options (years)	6	0.5-6	5-6	5-6

The Black-Scholes option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock-price volatility. The assumptions listed above represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, our recorded and pro forma stock-based compensation expense could have been different. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be materially different. The expected life of options has been computed using the simplified method as prescribed by Staff Accounting Bulletin No. 107.

6. *<u>VENDOR FINANCING</u>*:

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

	June 30, 2006	December 31, 2005
Inventory and working capital financing agreements:		
United States	$ 28,085	$ 30,092
Europe	15,623	12,071
Total	$ 43,708	$ 42,163

Inventory and Working Capital Financing Agreement, United States

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of IBM products in the United States, providing financing for eligible IBM inventory and for certain receivables up to $30.5 million through its expiration in March 2007. As of June 30, 2006, Supplies Distributors had $2.4 million of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $6.5 million and a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (8.75% as of June 30, 2006). The facility also includes a monthly service fee. The Company has classified the outstanding amounts under this credit facility as accounts payable in the consolidated balance sheets.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. (IBM Belgium) to finance their distribution of IBM products in Europe. The asset based credit facility with IBM Belgium provides up to 12.5 million Euros (approximately $15.9 million) in financing for purchasing IBM inventory and for certain receivables through its expiration in March 2007. As of June 30, 2006, Supplies Distributors European subsidiaries had 0.2 million euros ($0.2 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiaries to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors European subsidiaries, as well as collateralized guaranties of Supplies Distributors and PFSweb. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $6.5 million and a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at Euribor plus 1.5% (4.3% as of June 30, 2006). Supplies Distributors European subsidiaries pay a monthly service fee on the commitment. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

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7. *DEBT AND CAPITAL LEASE OBLIGATIONS;*

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

	June 30, 2006	December 31, 2005
Loan and security agreements, United States		
Supplies Distributors	$ 12,089	$ 11,673
eCOST	17	
PFS	5,706	6,640
Factoring agreement, Europe	2,482	576
Taxable revenue bonds	4,500	5,000
Master lease agreements	4,357	3,713
Other	450	313
Total	29,601	27,915
Less current portion of long-term debt	27,709	21,626
Long-term debt, less current portion	$ 1,892	$ 6,289

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Congress Financial Corporation (Southwest) (Congress) to provide financing for up to $25 million of eligible accounts receivable in the United States and Canada. As of June 30, 2006, Supplies Distributors had $4.6 million of available credit under this agreement. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement. Borrowings under the Congress facility accrue interest at prime rate to prime rate plus 0.25% or Eurodollar rate plus 2.25% to 2.75%, dependent on excess availability, as defined. The interest rate as of June 30, 2006 was 8.25% for $7.1 million of outstanding borrowings, 7.5% for $3.0 million of outstanding borrowings, and 7.4% for $2.0 million of outstanding borrowings. This agreement contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than $6.5 million and restricted cash of less than $5.0 million, and is restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Congress pursuant to which a security interest was granted to Congress for all U.S. and Canadian customer remittances received in specified bank accounts. At June 30, 2006 and December 31, 2005, these bank accounts held $0.7 million and $1.0 million, respectively, which was restricted for payment to Congress.

Loan and Security Agreement PFSweb

PFS has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to $7.5 million of eligible accounts receivable financing (Working Capital Advances) through March 2007 and $2.5 million of equipment financing (Equipment Advances) through June 15, 2008. Outstanding Working Capital Advances, $5.0 million as of June 30, 2006, accrue interest at prime rate plus 1% (9.25% as of June 30, 2006). Outstanding Equipment Advances, $0.7 million as of June 30, 2006, accrue interest at prime rate plus 1.5% (9.75% as of June 30, 2006). As of June 30, 2006, PFS had $2.1 million of available credit under the Working Capital Advance portion of this facility and no available credit under the Equipment Advance portion of this facility. In July 2006, the Company repaid the $5.0 million of Working Capital Advances outstanding as of June 30, 2006. The Comerica Agreement contains cross default provisions, various restrictions upon PFS ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, a minimum earnings before interest and taxes, plus

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depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the note receivable from Supplies Distributors to a maximum of $8 million. Comerica has provided approval for PFS to use $3.5 million in cash to fund the cash flow requirements of eCOST, which, as of June 30, 2006 PFS had advanced to eCOST. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb, Inc. The Comerica Agreement requires PFS to maintain a minimum cash balance of $1.3 million at Comerica.

Credit Facility eCOST

eCOST currently has an asset-based line of credit facility of up to $15.0 million with Wachovia Capital Finance Corporation (Western), which is collateralized by substantially all of eCOST s assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory. Outstanding amounts under the facility bear interest at rates ranging from the prime rate to the prime rate plus 0.5% (8.75% as of June 30, 2006), depending on eCOST s financial results. As of June 30, 2006, eCOST had $1.6 million of letters of credit outstanding and $1.9 million of available credit under this facility. In connection with the line of credit, eCOST entered into a cash management arrangement whereby eCOST s operating amounts are swept and used to repay outstanding amounts under the line of credit. The credit facility restricts eCOST s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth of $1 million, as defined. PFSweb has guaranteed all current and future obligations of eCOST under this line of credit.

Factoring Agreement

Supplies Distributors European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (Fortis) to provide factoring for up to 7.5 million euros (approximately $9.5 million) of eligible accounts receivables through March 2007. As of June 30, 2006, Supplies Distributors European subsidiary had approximately 0.1 million euros ($0.1 million) of available credit under this agreement. Borrowings accrue interest at Euribor plus 0.6% (3.5% at June 30, 2006). This agreement contains various restrictions upon the ability of Supplies Distributors European subsidiary to, among other things, merge, consolidate and incur indebtedness, as well as financial covenants, such as minimum net worth. This agreement is secured by a guarantee of Supplies Distributors, up to a maximum of 200,000 euros.

Taxable Revenue Bonds

PFSweb has a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) in connection with the issuance by the MBFC of $5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned the proceeds of the Bonds to PFSweb for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in the Company s Southaven, Mississippi distribution facility. The Bonds bear interest at a variable rate (5.35% as of June 30, 2006), as determined by Comerica Securities, as Remarketing Agent. PFSweb, at its option, may convert the Bonds to a fixed rate, to be determined by the Remarketing Agent at the time of conversion.

The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) in the initial face amount of $5.1 million issued by Comerica pursuant to a Reimbursement Agreement between PFSweb and Comerica under which PFSweb is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of January 2007 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. If the Letter of Credit is renewed or replaced, the Bonds require future principal repayments of $500,000 in January 2007 and $800,000 in each of January 2008 through 2012. PFSweb has established a sinking fund account with Comerica, which at June 30, 2006 includes $40,000 restricted for payments on the Bonds.

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Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with its covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of stockholders equity or net worth, and one or all of the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. In particular, in the event eCOST is unable to increase its revenue and/or gross profit from its present levels and does not achieve the operating efficiencies targeted to occur upon completion of its integration into the Company s infrastructure, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all or any portion of such obligations.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit Corporation (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of 3 to 5 years. The outstanding leasing transactions ($0.8 million and $0.7 million as of June 30, 2006 and December 31, 2005, respectively) are secured by the related equipment and letters of credit. The outstanding financing transactions ($16,000 and $0.2 million as of June 30, 2006 and December 31, 2005, respectively) are secured by a letter of credit.

The Company has a master agreement with a leasing company that provided for leasing transactions of certain equipment. The amounts outstanding under this agreement as of June 30, 2006 and December 31, 2005 were $0.7 million and $1.9 million, respectively, and are secured by the related equipment.

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

8. *SEGMENT INFORMATION*

The Company is organized into three operating segments: PFSweb is an international provider of integrated business process outsourcing solutions and operates as a service fee business; Supplies Distributors is a master distributor of primarily IBM products; and eCOST is a multi-category online discount retailer of new, close-out and refurbished brand-name merchandise.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Revenues (in thousands):				
PFSweb	$ 21,859	$ 23,833	$ 44,847	$ 44,198
Supplies Distributors	60,867	63,438	129,282	127,068
eCOST	28,783		50,572	
Eliminations	(2,205)	(2,401)	(4,729)	(4,531)
	$ 109,304	$ 84,870	$ 219,972	$ 166,735
Income (loss) from operations (in thousands):				
PFSweb	$ 220	$ (1,022)	$ (309)	$ (2,356)
Supplies Distributors	1,549	1,091	3,304	2,769
eCOST	(4,293)		(6,459)	

Eliminations				
	$ (2,524)	$ 69	$ (3,464)	$ 413

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	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Depreciation and amortization (in thousands):				
PFSweb	$ 1,545	$ 1,509	$ 3,106	$ 3,012
Supplies Distributors	3		3	
eCOST	289		480	
Eliminations				
	$ 1,837	$ 1,509	$ 3,589	$ 3,012
Capital expenditures (in thousands):				
PFSweb	$ 1,334	$ 488	$ 1,984	$ 2,561
Supplies Distributors	11		45	
eCOST	88		94	
Eliminations				
	$ 1,433	$ 488	$ 2,123	$ 2,561

	June 30, 2006	December 31, 2005
Assets (in thousands):		
PFSweb	$ 96,176	$ 60,337
Supplies Distributors	91,353	87,542
eCOST	41,436	
Eliminations	(50,688)	(16,153)
	$ 178,277	$ 131,726

9. *COMMITMENTS AND CONTENGENCIES*

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. The Company plans to dispute the notice. If the dispute is not resolved favorably, the Company could be assessed additional taxes from January 1, 2004. The Company has not accrued for the additional taxes, which through June 30, 2006 could be approximately $1.2 million, as it does not believe that it is probable that an additional assessment will be incurred.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek s Plan of Liquidation. The complaint alleges, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. The Company believes the claim has no merit and is vigorously defending the action.

In the ordinary course of business, one or more of the Company s clients may dispute Company invoices for services rendered or other charges. As of June 30, 2006, an aggregate of approximately $0.4 million of client invoices were in dispute. The Company believes it will resolve these disputes in its favor and has not recorded any specific reserve for such disputes.

On July 12, 2004, eCOST received correspondence from MercExchange LLC alleging infringement of MercExchange s U.S. patents relating to e-commerce and offering to license its patent portfolio to eCOST. On July 15, 2004, eCOST received a follow-up letter from MercExchange specifying which of its technologies MercExchange believed infringed certain of its patents, alone or in combination with technologies provided by third parties. Some of those patents are currently being litigated by third parties, and eCOST is not involved in those proceedings. In addition, three of the four patents identified by MercExchange are under reexamination at the U.S. Patent and Trademark Office, which may or may not result in the modification of those claims. In the July 15 letter, MercExchange also advised eCOST that it has a number of applications pending for additional patents. MercExchange has filed lawsuits alleging

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infringement of some or all of its patents against third parties, resulting in settlements or verdicts in favor of MercExchange. At least one such verdict was appealed to the United States Court of Appeals for the Federal Circuit and was affirmed in part. Based on eCOST s investigation of this matter to date, eCOST believes that its current operations do not infringe any valid claims of the patents identified by MercExchange in these letters. There can be no assurance, however, that such claims will not be material or adversely affect eCOST s business, financial position, results of operations or cash flows.

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

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

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like seek, strive, believe, expect, anticipate, predict, potential, continue, will, may, could, intend, plan, target and estimate or si are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K and Form 10-K/A for the year ended December 31, 2005, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

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

foreign currency risks and other risks of operating in foreign countries;

potential litigation;

potential delisting;

our dependency on key personnel;

the impact of new accounting standards and rules regarding revenue recognition, stock options and other matters;

changes in accounting rules or the interpretations of those rules;

our ability to raise additional capital or obtain additional financing;

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

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

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

the transition costs resulting from our merger with eCOST;

our ability to successfully integrate eCOST into our business to achieve the anticipated benefits of the merger:

eCOST s potential indemnification obligations to its former parent;

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

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

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We have based these statements on our current expectations about future events. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future. In addition to the risks set forth in our Annual Report on From 10-K and Form 10-K/A for the year ended December 31, 2005 under the caption Risk Factors , there may be additional risks that we do not currently view as material or that are not presently known.

Overview

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

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

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

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

Our second business segment is a product revenue model. In this segment, we are a master distributor of product for IBM and certain other clients. In this capacity, we purchase, and thus own, inventory and recognize the corresponding product revenue. As a result, upon the sale of inventory, we own the accounts receivable. Freight costs billed to customers are reflected as components of product revenue. This business segment requires significant working capital requirements, for which we have senior credit facilities to provide for more than $95 million of available financing.

Our third business segment is a web-commerce product revenue model focused on the sale of products to a broad range of consumer and small business customers. In this segment we operate as a multi-category online discount retailer of new, close-out and refurbished brand-name merchandise. Our web-commerce product line currently offers more than 100,000 products in several primary merchandise categories, including computer hardware and software, home electronics, digital imaging, watches and jewelry, housewares, DVD movies, video games, travel, bed and bath, apparel and accessories, licensed sports gear and cellular/wireless. Our product revenue in this segment is reduced by consumer chargeback activities and credit card fraud matters.

Growth is a key element to achieving our future goals, including achieving and maintaining sustainable profitability. Growth in our service fee business is driven by two main elements: new client relationships and organic growth from existing clients. We have refocused our sales efforts on larger contracts with brand-name companies; however, we have seen the sales cycle lengthen and the number of new contract signings slow down as compared to prior periods. Our results for the six months ended June 30, 2006 include approximately $1.6 million of new revenue including certain incremental projects. Growth within our product revenue business is primarily driven by our ability to attract new master distributor arrangements with IBM or other manufacturers and the sales and marketing efforts of the manufacturers and third party sales partners. We currently expect growth in our product revenue business to be modest. Growth within our web-commerce product revenue model is primarily driven by eCOST s ability to increase sales and expand its product line.

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

Our expenses comprise primarily four categories: 1) cost of product revenue, 2) cost of service fee revenue, 3) cost of pass-through revenue and 4) selling, general and administrative (SG&A) expenses.

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

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

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

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

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

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

- In 2003 we completed a private placement of approximately 1.6 million shares of our common stock to certain investors that provided net proceeds of approximately $3.2 million. In January 2005, we issued an additional 0.4 million shares of common stock to certain of these investors who exercised warrants issued in the private placement. The warrants exercised provided $1.3 million of additional proceeds.

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In 2004 we received proceeds of $5.0 million of taxable revenue bonds to finance capital additions to our new facility in Southaven, MS.

In June 2006, we completed another private placement of 5.0 million shares of our common stock to certain investors that provided net proceeds of $4.8 million.

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)
Product revenue, net	82.0%	74.8%	81.8%	76.2%
Service fee revenue	14.8	19.2	14.6	18.2
Pass-through revenue	3.2	6.0	3.6	5.6
Total revenues	100.0	100.0	100.0	100.0
Cost of product revenue (as % of product revenue)	94.2	94.0	93.9	93.8
Cost of service fee revenue (as % of net service fee revenue)	70.1	74.3	70.8	75.3
Cost of pass-through revenue (as % of pass-through revenue)	100.0	100.0	100.0	100.0
Total costs of revenues	90.8	90.5	90.7	90.8
Gross profit	9.2	9.5	9.3	9.2
Selling, general and administrative expenses	11.5	9.4	10.9	8.9
Income (loss) from operations	(2.3)	0.1	(1.6)	0.3
Interest expense, net	0.5	0.5	0.4	0.5
Loss before income taxes	(2.8)	(0.4)	(2.0)	(0.2)
Income tax expense	0.1	0.2	0.2	0.2
Net loss	(2.9)%	(0.6)%	(2.2)%	(0.4)%

Results of Operations for the Interim Periods Ended June 30, 2006 and 2005

Product Revenue. Product revenue was $89.7 million for the three months ended June 30, 2006, as compared to $63.4 million for the three months ended June 30, 2005, an increase of $26.3 million, or 41.3%. Excluding the $28.8 million of product revenue of eCOST following its acquisition in February 2006, product revenue decreased $2.5 million, or 4.1%, primarily due to lower volume and timing of product promotions. Product revenue for the six months ended June 30, 2006 was $179.9 million as compared to $127.1 million, an increase of $52.8 million, or 41.5%, in the same period of the prior year. Excluding the $50.6 million of product revenue of eCOST following its acquisition in February 2006, revenue increased $2.2 million, or 1.7%, primarily due to a certain vendor-sponsored product promotion in the first quarter of 2006.

Service Fee Revenue. Service fee revenue was $16.2 million for the three months ended June 30, 2006 as compared to $16.3 million for the three months ended June 30, 2005, a decrease of $0.1 million or 0.1%. Service fees for the six months ended June 30, 2006 and 2005 were $32.1 million and $30.4 million, respectively, an increase of $1.7 million or 5.7%. Service fee revenue for the three months and six months ended June 30, 2006 and 2005 included increased service fees generated from incremental projects with certain client relationships. The change in service fee revenue is shown below ($ millions):

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	Three Months	Six Months
Period ended June 30, 2005	$ 16.3	$ 30.4
New service contract relationships, including certain incremental projects under new contracts	0.9	1.6
Change in existing client service fees from organic growth and certain incremental projects with existing clients	(0.4)	1.3
Terminated clients not included in 2006 revenue	(0.6)	(1.2)
Period ended June 30, 2006	$ 16.2	$ 32.1

Cost of Product Revenue. Cost of product revenue was $84.5 million for the three months ended June 30, 2006, as compared to $59.6 million for the three months ended June 30, 2005, an increase of $24.9 million or 41.7%. Excluding the $27.7 million of cost of product revenue of eCOST following its acquisition in February 2006, cost of product revenue decreased $2.8 million or 4.8%. Cost of product revenue, excluding eCOST, decreased primarily as the result of decreased sales volumes of certain products. Cost of product revenue, as a percent of product revenue, excluding the impact of eCOST, was 93.3% during the three months ended June 30, 2006 and 94.0% during the three months ended June 30, 2005. The resulting gross profit margin was 6.7% for the three months ended June 30, 2006 and 6.0% for the three months ended June 30, 2005. eCOST s cost of product revenue, as a percentage of product revenue was 96.3% during the three month period ended June 30, 2006. The resulting gross margin for eCOST was 3.7% during the same period, which is lower than we expected primarily due to elevated levels of fraudulent credit card chargeback activity in the second quarter of 2006 that resulted in approximately $0.7 million higher than normal chargebacks. Such activity is accounted for as a reduction in product revenue resulting in lower gross margin. We expect that this fraudulent credit card chargeback activity will result in an incremental $0.9 million reduction of our gross margin in the quarter ending September 30, 2006. In addition, eCOST recorded an incremental provision of excess and obsolete inventory of $0.3 million in the June 2006 quarter due to an increase in slower moving product on hand. Cost of product revenue was $168.8 million for the six months ended June 30, 2006, as compared to $119.3 million for the six months ended June 30, 2005, an increase of $49.5 million or 41.6%. Excluding the $48.1 million of cost of product revenue of eCOST following its acquisition in February 2006, cost of product revenue increased $1.4 million or 1.2%. Cost of product revenue, excluding eCOST, increased primarily as the result of the higher sales volume in the first half of the year. Cost of product revenue, as a percent of product revenue, excluding the impact of eCOST, was 93.4% during the six months ended June 30, 2006 and 93.8% during the six months ended June 30, 2005. The resulting gross profit margin was 6.6% for the six months ended June 30, 2006 and 6.2% for the six months ended June 30, 2005. eCOST s cost of product revenue, as a percentage of product revenue was 95.2% during the six month period ended June 30, 2006. The resulting gross margin for eCOST was 4.8% during the same period which is lower than we expected primarily due to elevated levels of fraudulent credit card activity in the 2006 period, an increased provision for excess and obsolete inventory, and the impact of a $0.4 million loss applicable to a sales transaction to a former eCOST customer in the March 2006 quarter. SG&A expenses in the three and six month periods ended June 30, 2006 included $0.2 million and $0.5 million, respectively, of costs applicable to stock option expense, which were zero in the prior year.

Cost of Service Fee Revenue. Cost of service fee revenue was $11.4 million for the three months ended June 30, 2006, as compared to $12.1 million during the three months ended June 30, 2005, a decrease of $0.7 million or 5.8%. The resulting service fee gross profit was $4.8 million or 29.9% of service fee revenue, during the three months ended June 30, 2006 as compared to $4.2 million, or 25.7% of service fee revenue for the three months ended June 30, 2005. Cost of service fee revenue was $22.7 million for the six months ended June 30, 2006, as compared to $22.9 million during the six months ended June 30, 2005, a decrease of $0.2 million or 0.1%. The resulting service fee gross profit was $9.4 million or 29.2% of service fee revenue, during the six months ended June 30, 2006 as compared to $7.5 million, or 24.7% of service fee revenue for the six months ended June 30, 2005. Our gross profit as a percent of service fees increased in the current periods primarily due to higher gross margins on certain client project revenue as well as the prior year having lower gross margins on certain new contracts, including certain start up costs. As we add new service fee revenue in the future, we currently intend to target the underlying contracts to earn an average gross profit percentage of 25-35%, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors.

Selling, General and Administrative Expenses. SG&A expenses were $12.5 million for the three months ended June 30, 2006, or 11.5% of total net revenues, as compared to $8.0 million, or 9.4% of total net revenues, for the three months ended June 30, 2005. Excluding the $5.4 million of SG&A expenses of eCOST following its acquisition in February 2006, SG&A expenses were $7.1 million, or 8.9% of total net revenues. The decrease in SG&A, excluding eCOST, for the three months ended June 30, 2006 compared to 2005 is primarily due to the favorable impact of exchange rates related to our European and Canadian operations, and that 2005 results included incremental legal fees related to a lawsuit filed in May 2005 and incremental sales and marketing expenses. SG&A expenses were $23.9 million for the six months ended June 30, 2006, or 10.9% of total net revenues, as compared to $14.9 million, or 8.9% of total net revenues, for the six months ended June 30, 2005. Excluding the $8.9 million of SG&A expenses of eCOST following its acquisition in February 2006, SG&A expenses were $15.0 million or 8.8% of total net revenues. Upon the conclusion of the integration process of eCOST into our current infrastructure, currently targeted for the third quarter, we expect to realize certain SG&A savings through the reduction of certain eCOST overhead expenses, changes in corporate infrastructure and a reduction in integration related costs.

Interest Expense, net. Net interest expense was $0.5 million and $0.9 million for the three and six

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months ended June 30, 2006 respectively as compared to $0.5 million and $0.8 million for the three and six months ended June 30, 2005.

Income Taxes. For the three months ended June 30, 2006 and 2005, we recorded a tax provision of $0.1 million primarily associated with our subsidiary Supplies Distributors Canadian and European operations. For the six month periods ended June 30, 2006 and 2005, we recorded a tax provision of $0.4 million for those same operations. We did not record an income tax benefit associated with our consolidated net loss in our U.S. operations. A valuation allowance has been provided for our net U.S. deferred tax assets as of June 30, 2006 and December 31, 2005, which are primarily related to our net operating loss carryforwards. We did not record an income tax benefit for our PFSweb Canadian pre-tax losses in the current or prior periods. Due to the consolidation of Supplies Distributors, in the future we anticipate that we will continue to record an income tax provision associated with Supplies Distributors Canadian and European results of operations.

Liquidity and Capital Resources

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

Net cash used in operating activities was $6.3 million for the six months ended June 30, 2005, and primarily resulted from an increase in accounts receivable of $2.9 million, a $3.2 million increase in inventories, a $2.6 million decrease in accounts payable, accrued expenses and other liabilities and partially offset by net income, as adjusted for non-cash items, of $2.2 million. The increase in accounts receivable was primarily due to increased service fee billings for certain client relationships and the timing of payments received by certain clients.

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

Net cash used in investing activities for the six months ended June 30, 2005 totaled $1.2 million, representing capital expenditures partially offset by a decrease in restricted cash.

Capital expenditures have historically consisted primarily of additions to upgrade our management information systems, and general expansion of our facilities, both domestic and foreign. We expect to incur capital expenditures to support new contracts and anticipated future growth opportunities. Based on our current client business activity and our targeted growth plans, we anticipate that our total investment in upgrades and additions to facilities and information technology services for the upcoming twelve months will be approximately $4 to $7 million, although additional capital expenditures may be necessary to support the infrastructure requirements of new clients as well as the eCOST infrastructure. To maintain our current operating cash position, a portion of these expenditures may be financed through debt, operating or capital leases or additional equity. We may elect to modify or defer a portion of such anticipated investments in the event that we do not obtain the financing or achieve the revenue necessary to support such investments.

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

Net cash provided by financing activities was approximately $7.3 million for the six months ended June 30, 2005, primarily representing $5.1 million of proceeds from debt and $1.9 million from the issuance of common stock pursuant to our employee stock purchase and stock option programs and warrant exercises.

Our liquidity could be impacted significantly as a result of the merger with eCOST. During 2005 and the six month period ended June 30, 2006, eCOST experienced a significant net usage of cash primarily due to certain operational difficulties related to its transition as a separate company following its spin-off from its parent company in April 2005 as well as declining sales and increasing inventory and accounts receivable balances. As a result, we are anticipating, during the process of transitioning and integrating the eCOST operations, of having to support eCOST s cash needs to help them achieve a stabilized operational position. The amount of cash needed to support eCOST operations depends upon the financing available as well as the length of time it takes to successfully transition and incorporate eCOST into our current infrastructure and eCOST s ability to improve its financial results.

We currently expect that eCOST, as part of a combined Company, should achieve annual recurring cost savings of approximately $4 to $5 million in the first full year of operation following the integration. These savings are expected to result from, among other things, the reduction of certain overhead expenses, changes in corporate infrastructure and reduced freight costs, although there can be no assurance that these cost savings will be achieved. We currently are targeting eCOST to be nearly fully incorporated into our infrastructure by the end of the third quarter of 2006 at which time we expect to begin realizing the full potential of the expected cost savings.

During the six months ended June 30, 2006, our working capital decreased to $21.0 million from $23.4 million at December 31, 2005, primarily as a result of the reclassification of the $4.5 million in taxable revenue bonds to short-term debt due as the related letters of credit securing the taxable revenue bonds matures in January 2007 and the use of cash related to the integration activities of eCOST into the PFS infrastructure. We are targeting to renew the letter of credit facility with the bank during 2006 to present this as a long-term liability again in the future, however we can provide no assurance as to our ability to do so. A portion of these cash outflows were offset by the net proceeds from the sale of our common stock in a private placement transaction. To obtain additional financing in the future, in addition to our current cash position, we plan to evaluate various financing alternatives including the sale of equity, utilizing capital or operating leases, borrowing under our credit facilities, expanding our current credit facilities, entering into new debt agreements or transferring to third parties a portion of our subordinated loan balance due from Supplies Distributors. In conjunction with certain of these alternatives, we may be required to provide certain letters of credit to secure these arrangements. No assurances can be given that we will be successful in obtaining any additional financing or the terms thereof. We currently believe that our cash position, financing available under our credit facilities and funds generated from operations (including our anticipated revenue growth and/or cost reductions to offset lower than anticipated revenue growth) will satisfy our presently known operating cash needs, our working capital and capital expenditure requirements, our lease obligations, and additional loans to our subsidiaries Supplies Distributors and eCOST, if necessary, for at least the next twelve months.

The following is a schedule of our total contractual cash obligations which is comprised of operating leases, debt, vendor financing and capital leases (including interest) as of June 30, 2006, (in millions):

		Payments Due By Period			
Contractual Obligations	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Debt and vendor financing	$ 69,520	$ 68,989	$ 501	$ 30	$
Capital lease obligations	4,315	2,838	1,356	121	
Operating leases	22,149	8,241	10,267	3,067	574
Total	$ 95,984	$ 80,068	$ 12,124	$ 3,218	$ 574

In support of certain debt instruments and leases, as of June 30, 2006, we had $0.3 million of cash restricted as collateral for letters of credit. The letters of credit expire in 2007. As of June 30, 2006, we had $1.1 million of cash restricted for payment of capital expenditures or repayments to lenders. In addition, as described above, we have provided collateralized guarantees to secure the repayment of certain of our subsidiaries credit facilities. Many of our debt facilities include both financial and non-financial covenants, and also include cross default provisions applicable to other agreements. To the extent we fail to comply with our debt covenants, including the monthly financial covenant requirements and our required level of shareholders equity, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. In particular, in the event eCOST is unable to increase its revenue and/or gross profit from its present levels and does not achieve the operating efficiencies targeted to occur upon completion of its integration into the Company s infrastructure, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and payment under the Company parent guaranty. A requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of June 30, 2006, we were in compliance with all debt covenants. We do not have any other material financial commitments, although future client contracts may require capital expenditures and lease commitments to support the services provided to such clients.

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

To finance their distribution of IBM products, Supplies Distributors and its subsidiaries have short-term credit facilities with IBM Credit LLC (IBM Credit) and IBM Belgium Financial Services S.A. (IBM Belgium). We have provided a collateralized guaranty to secure the repayment of these credit facilities. These asset-based credit facilities provided financing for up to $30.5 million and up to 12.5 million Euros (approximately $15.9 million) with IBM Credit and IBM Belgium, respectively. These agreements expire in March 2007.

Supplies Distributors also has a loan and security agreement with Congress Financial Corporation (Southwest) (Congress) to provide financing for up to $25 million of eligible accounts receivables in the United States and Canada. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement.

Supplies Distributors European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (Fortis) to provide factoring for up to 7.5 million Euros (approximately $9.5 million) of eligible accounts receivables through March 2007.

These credit facilities contain cross default provisions, various restrictions upon the ability of Supplies Distributors and its subsidiaries to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as cash flow from operations, annualized revenue to working capital, net profit after tax to revenue, minimum net worth and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, we are required to maintain a subordinated loan to Supplies Distributors of no less than $6.5 million, maintain restricted cash of less than $5.0 million, are restricted with regard to transactions with related parties (including entities directly or indirectly owned by PFSweb, Inc.), indebtedness and changes to capital stock ownership structure and a minimum shareholders equity of at least $18.0 million. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors or its subsidiaries under these facilities if they are unable to do so. We have also provided a guarantee of the obligations of Supplies Distributors and its subsidiaries to IBM, excluding the trade payables that are financed by IBM credit.

Our subsidiary, Priority Fulfillment Services, Inc. (PFS), has entered into a Loan and Security Agreement with Comerica Bank (Comerica), which provides for up to $7.5 million of eligible accounts receivable financing through March 2007, and up to $2.5 million of eligible equipment purchases through June 2008. We entered this Agreement to supplement our existing cash position, and provide funding for our current and future operations, including our targeted growth. The Agreement contains cross default provisions, various restrictions upon our ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to subsidiaries, affiliates and related parties (including entities

directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, and a minimum liquidity ratio, as defined. The agreement also limits PFS ability to increase the subordinated loan to Supplies Distributors to more than $8.0 million or advance more than $3.5 million to eCOST without the lender s approval. The agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb.

In 2003, we entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which we issued and sold an aggregate of 1.6 million shares of our common stock, par value $.001 per share (the Common Stock), at $2.16 per share, resulting in gross proceeds of $3.4 million. After deducting expenses, the net proceeds were approximately $3.2 million. In addition to the Common Stock, the investors received one-year warrants to purchase an aggregate 525,692 shares of Common Stock at an exercise price of $3.25 per share and four-year warrants to purchase an aggregate of 395,486 shares of Common Stock at an exercise price of $3.30 per share. In January 2005, 394,865 of the one-year warrants were exercised prior to their expiration, generating net proceeds to us of $1.3 million, and 131,277 of the one-year warrants expired unexercised. As a result of the merger with eCOST and the private placement transaction of our common stock in June 2006 (discussed below), the exercise price of the four-year warrants has been adjusted to $2.31 per share and the number of warrants has been adjusted to 564,980. In addition, in connection with the merger with eCOST, we assumed outstanding warrants to issue an aggregate of 36,210 shares of common stock at an exercise price of $2.00 per share, subject to the terms set forth therein.

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

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

To the extent we fail to comply with the various debt covenants described above, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. Any requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of June 30, 2006, we were in compliance with all debt covenants.

Through our merger with eCOST, we plan to align the core strengths of each company, to leverage our operational infrastructure and technology expertise with eCOST s customer base and supplier relationships. Specifically, we are targeting for eCOST to achieve $4 to $5 million in annual cost savings in the first full year of operation following the integration. These savings are expected to result from, among other things, reductions in the following costs:

Certain redundant administrative and public company activities;

Excess capacity and other related facility expenses;

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- Technology, telecommunications and operational costs; and

- Overall outbound freight costs due to additional freight options.

We currently are targeting eCOST to be nearly fully incorporated into our infrastructure by the end of the third quarter of 2006 at which time we expect to begin realizing the full potential of the expected cost savings.

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

- Increase the number of virtual warehouse partnerships for both electronics and non-electronic goods;

- Develop higher margin non-product and service categories;

- Expand international sales, particularly in Europe and Canada, where we maintain a presence; and

- Utilize our stronger financial platform to enhance eCOST s working capital resources to expand access to exclusive products and deals.

We can provide no assurance that such plans or the underlying financial benefits will be achieved. Additionally, even with such plans, we expect that eCOST will operate at a loss during 2006 and will require funding to support its operations.

eCOST currently has an asset-based line of credit facility of up to $15.0 million with Wachovia Capital Finance Corporation (Western), which is collateralized by substantially all of eCOST s assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and letter of credit availability is limited to a percentage of accounts receivable and inventory. Outstanding amounts under the facility bear interest at rates ranging from the prime rate to the prime rate plus 0.5% (8.75% as of June 30, 2006), depending on eCOST s financial results. As of June 30, 2006, eCOST had $1.6 million of letters of credit outstanding and $1.9 million of available credit under this facility. The credit facility restricts eCOST s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth of $1 million, as defined. PFSweb has guaranteed all current and future obligations of eCOST under this line of credit.

eCOST has historically incurred significant operating losses and used cash to fund its operations. As a result, we expect that we will be required to invest cash to fund eCOST s operations, which we may not be able to do without approval from our lenders. The amount of cash needed to support eCOST operations depends upon the financing available under its credit line as well as the length of time it takes to successfully transition and incorporate eCOST into our current infrastructure. Through August 1, 2006, we have advanced $8.2 million to eCOST to fund eCOST s cash flow requirements. We currently expect that it will be necessary to invest further cash to fund eCOST s cash flow requirements. In such event, we will seek approval from our lenders to provide such funds. We can provide no assurance that we will receive approval from our lenders, or any terms or conditions required by our lenders in order to obtain such approval. In addition, PFSweb has provided a guaranty of eCOST s bank line of credit and certain eCOST vendor trade payables.

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

We receive municipal tax abatements in certain locations. During 2004 we received notice from a municipality that we did not satisfy certain criteria necessary to maintain the abatements. We plan to dispute the notice. If the dispute is not resolved favorably, we could be assessed additional taxes from January 1, 2004. We have not accrued for the additional taxes, which through June 30, 2006 could be approximately $1.2 million in the aggregate, as we do not believe that it is probable that an additional assessment will be incurred.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was

created pursuant to Daisytek s Plan of Liquidation. The complaint alleges, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. We believe the claim has no merit and are vigorously defending the action.

In the ordinary course of business, one or more of the Company s clients may dispute Company invoices for services rendered or other charges. As of June 30, 2006, an aggregate of approximately $0.4 million of client invoices were in dispute. The Company believes it will resolve these disputes in its favor and has not recorded any specific reserve for such disputes.

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

Seasonality

The seasonality of our service fee business is dependent upon the seasonality of our clients business and sales of their products. Accordingly, our management must rely upon the projections of our clients in assessing quarterly variability. We believe that with our current client mix and their current business volumes, our service fee business activity will be at it lowest in the quarter ended March 31. We anticipate that our product revenue will be highest during the quarter ended December 31.

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

Inflation

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

Critical Accounting Policies

A description of critical accounting policies is included in Note 2 to the accompanying unaudited interim condensed consolidated financial statements. For other significant accounting policies, see Note 2 to the consolidated financial statements in our December 31, 2005 Annual Report on Form 10-K and Form 10-K/A.

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ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

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

Interest Rate Risk

Our interest rate risk is limited to our outstanding balances on our inventory and working capital financing agreements, taxable revenue bonds, loan and security agreements and factoring agreement for the financing of inventory, accounts receivable and certain other receivables and certain equipment, which amounted to $70.4 million at June 30, 2006. A 100 basis point movement in interest rates would result in approximately $0.3 million annualized increase or decrease in interest expense based on the outstanding balance of these agreements at June 30, 2006.

Foreign Exchange Risk

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

ITEM 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act of 1934. An evaluation of the effectiveness of the Company s disclosure controls and procedures as of the end of the period covered by this report was completed by the Company s principal executive officer and principal accounting officer within 90 days prior to the filing date of this report. A material weakness (within the meaning of the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No.2) is a control deficiency, or aggregation of control deficiencies, that results in more than a remote risk that a material misstatement in our annual or interim financial statements will not be prevented or detected.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company s annual or interim financial statements that is more than inconsequential will not be prevented or detected. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In conjunction with our review of our internal controls over financial reporting, the following material weakness was identified as of June 30,2006:

The Company acquired eCOST.com, Inc. (eCOST), a wholly owned subsidiary, on February 1, 2006. In the June 2006 quarter, problems with eCOST s credit card systems controls resulted in increased fraudulent credit card activity. Further problems with eCOST s credit card systems controls arose during the course of a systems conversion in late June 2006 resulting in even higher fraudulent credit card activity. These system control issues have been identified and we believe that these issues and the material control weakness were resolved in July 2006.

Changes in Internal Control-

In June 2006, one of the Company s subsidiaries, eCOST.com, completed a computer system conversion, resulting in material changes to the eCOST.com internal control environment.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

None

ITEM 1A. Risk Factors

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

Risks Related to PFSweb

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

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

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

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

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

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

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

As of June 30, 2006, our total credit facilities outstanding, including debt, capital lease obligations and our vendor accounts payable related to financing of IBM product inventory, was approximately $74 million.

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Certain of the credit facilities have maturity dates in calendar year 2007 or after, but are classified as current liabilities in our consolidated financial statements. We cannot provide assurance that our credit facilities will be renewed by the lending parties. Additionally, these credit facilities include both financial and non-financial covenants, many of which also include cross default provisions applicable to other agreements. These covenants also restrict our ability to transfer funds among our various subsidiaries, which may adversely affect the ability of our subsidiaries to operate their businesses or comply with their respective loan covenants. We cannot provide assurance that we will be able to maintain compliance with these covenants. Any non-renewal or any default under any of our credit facilities would have a material adverse impact upon our business and financial condition. In addition we have provided $6.5 million of subordinated indebtedness to Supplies Distributors, the minimum level required under certain credit facilities as of June 30, 2006. The maximum level of this subordinated indebtedness to Supplies Distributors that may be provided without approval from our lenders is $8.0 million. The restrictions on increasing this amount without lender approval may limit our ability to comply with certain loan covenants or further grow and develop Supplies Distributors business. We have guaranteed most of the indebtedness of Supplies Distributors. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors by its lenders to the extent Supplies Distributors is unable to do so. We have also guaranteed eCOST s $15 million credit line with Wachovia, as well as certain of its vendor trade payables. We currently expect that it may be necessary to provide additional guarantees of certain eCOST vendor trade payables in the future.

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

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

We are subject to risks associated with our international operations.

We currently operate a 150,000 square foot distribution center in Liege, Belgium and a 13,000 square foot distribution center in Richmond Hill, Canada, near Toronto, both of which currently have excess capacity. We cannot assure you that we will be successful in expanding in these or any additional international markets. In addition to the uncertainty regarding our ability to generate revenue from foreign operations and expand our international presence, there are risks inherent in doing business internationally, including:

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

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

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

Our future capital needs are difficult to predict. We may require additional capital to take advantage of unanticipated opportunities, including strategic alliances and acquisitions and to fund capital expenditures, or to respond to changing business conditions and unanticipated competitive pressures. In addition, eCOST is now a wholly-owned subsidiary and is expected to need additional financing as well. We may also require additional funds to finance operating losses, including continuing operating losses currently anticipated to be incurred by eCOST.

Should these circumstances arise, our existing cash balance and credit facilities may be insufficient and we may need to raise additional funds either by borrowing money or issuing additional equity. We cannot assure you that such resources will be adequate or available for all of our future financing needs. Our inability to finance our growth, either internally or externally, may limit our growth potential and our ability to execute our business strategy. If we are successful in completing an additional equity financing, this could result in further dilution to our stockholders or reduce the market value of our common stock.

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

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

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

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

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

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

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

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

Substantially all of our Supplies Distributors product revenue was generated by sales of product purchased under master distributor agreements with IBM and is dependent on IBM s business. Our Supplies Distributor product revenue business is dependent upon our master distributor relationship with IBM and the continuing market for IBM products. A termination of the relationship with IBM or a decline in customer demand for such products could have a material adverse effect on our business. Sales to one customer accounted for approximately 11% of our consolidated product revenues for the six months ended June 30, 2006. The loss of any one or more of such customers, or non-payment of any material amount by these or any other customer, would have a material adverse effect upon our business.

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

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

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

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

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

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

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

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

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

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

We are subject to disputes with clients, customers and other authorities which, if not resolved in our favor, may materially adversely affect our results of operations.

In the ordinary course of our business, one or more of our clients or customers may dispute our invoices for services rendered or other charges. As of June 30, 2006, an aggregate of approximately $0.4 million of our invoices were in dispute. Although we believe it will resolve these disputes in our favor, the failure to do so may have a material adverse effect on our results of operations. We also receive municipal tax abatements in certain locations. During 2004 we received notice from a municipality that we did not satisfy certain criteria necessary to maintain the abatements. We plan to dispute the notice, but if the dispute is not resolved favorably, additional taxes of approximately $1.2 million through June 30, 2006 could be assessed against us.

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

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

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

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

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

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

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

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

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

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

Risks Related to the Business Process Outsourcing Industry

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

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

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

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our services and the underlying network infrastructure. If we are unable to adapt to changing market conditions, client requirements or emerging industry standards, our business could be adversely affected. The internet and e-commerce environments are characterized by rapid technological change, changes in user requirements and preferences, frequent new product and service introductions embodying new technologies and the emergence of new industry standards and practices that could render our technology and systems obsolete. Our success will depend, in part, on our ability to both internally develop

and license leading technologies to enhance PFSweb s existing services and develop new services. We must continue to address the increasingly sophisticated and varied needs of our clients and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. The development of proprietary technology involves significant technical and business risks. We may fail to develop new technologies effectively or to adapt our proprietary technology and systems to client requirements or emerging industry standards.

Risks Related to Our Stock

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

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

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

As of June 30, 2006, we had issued and outstanding 601,190 warrants to purchase common stock (having a weighted average exercise price of $2.29 per share). In addition, as of June 30, 2006, we have an aggregate of 6,134,144 stock options outstanding to employees, directors and others with a weighted average exercise price of $1.29 per share. The shares of common stock that may be issued upon exercise of these warrants and options may be resold into the public market. Sales of substantial amounts of common stock in the public market as a result of the exercise of these warrants or options, or the perception that future sales of these shares could occur, could reduce the market price of our common stock and make it more difficult to sell equity securities in the future.

Our common stock is at risk for delisting from the Nasdaq Capital Market. If it is delisted, our stock price and your liquidity may be impacted. We may implement a stock split in order to comply with Nasdaq listing requirements.

Our common stock is currently listed on the Nasdaq Capital Market. Nasdaq has requirements that a company must meet in order to remain listed on the Nasdaq Capital Market. These requirements include maintaining a minimum closing bid price of $1.00. The closing bid price for our common stock has had periods of time when it traded below $1.00 for more than 30 consecutive trading days. As of August 14, we currently meet all the minimum continued listing requirements for the Nasdaq Capital Market. However, if we fail to meet the $1.00 minimum bid price, we may implement a stock split in order to increase the trading price of our common stock.

If we fair to maintain the standards necessary to be quoted on the Nasdaq Capital Market and our common stock is delisted, trading in our common stock would be conducted on the OTC Bulletin Board as long as we continue to file reports required by the Securities and Exchange Commission. The OTC Bulletin Board is generally considered to be a less efficient market than the Nasdaq Capital Market, and our stock price, as well as the liquidity of our Common Stock, may be adversely impacted as a result.

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

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

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

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

Risks Related to our Merger with eCOST

We may fail to realize the anticipated synergies, cost savings, growth opportunities and other benefits expected from the merger, which could adversely affect the value of our common stock.

We entered into a merger with eCOST with the expectation that the merger will result in synergies, cost savings, growth opportunities and other benefits to the combined company. However, the ability to realize these anticipated benefits of the merger will depend, in part, on our ability to integrate the business of eCOST with our business. The integration of two independent companies is a complex, costly and time-consuming process. It is possible that these integration efforts will not be completed as smoothly as planned or that these efforts will divert management attention for an extended period of time. Delays encountered in the integration process could have a material adverse effect on the revenues, expenses, operating results and financial condition for us. There can be no assurance that we will realize any of the anticipated benefits from our merger with eCOST.

Stockholders may receive a lower return on their investment after the merger.

Although we believe that the merger will create financial, operational and strategic benefits for the combined company and its stockholders, these benefits may not be achieved. The combination of our businesses, even if conducted in an efficient, effective and timely manner, may not result in combined financial performance that is better than what our company would have achieved independently if the merger had not occurred.

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

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

Uncertainties associated with the merger may cause us and eCOST to lose key personnel.

Our current and prospective employees and eCOST employees may experience uncertainty about their future roles with the combined company until or after strategies with regard to the combined company are announced or executed. In addition, eCOST does not have employment agreements with any of its key employees other than with its Chief Executive Officer, Adam Shaffer. These uncertainties may adversely affect PFSweb s and eCOST s ability to attract and retain key management, sales, marketing and technical personnel. If a substantial number of key employees leave as a result of the merger, or the combined company fails to attract key personnel, the combined company s business could be adversely affected.

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

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

Risks Related to eCOST

eCOST may not be able to achieve or maintain profitability.

eCOST has incurred continuing operating losses and may not be able to achieve or maintain profitability on a quarterly or annual basis. eCOST s ability to achieve or maintain profitability depends on a number of factors, including its ability to:

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

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

eCOST needs to obtain additional financing and there can be no assurance that it will be able to obtain additional financing on commercially reasonable terms or at all. eCOST s failure to obtain additional financing or its inability to obtain financing on acceptable terms could materially adversely affect its ability to achieve profitability and grow its business.

eCOST s operating results are difficult to predict.

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

- price competition that results in lower sales volumes, lower profit margins, or net losses;
- fluctuations in coupon redemption rates;
- the amount, timing and impact of advertising and marketing costs;
- eCOST s ability to successfully implement new technologies or software systems;
- eCOST s ability to obtain sufficient financing;
- changes in the number of visitors to the eCOST website or eCOST s inability to convert those visitors into customers;

technical difficulties, including system or Internet failures;

fluctuations in the demand for eCOST products or overstocking or understocking of products;

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

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

changes in the mix of products that eCOST sells; and fluctuations in levels of inventory theft, damage or obsolescence.

The failure of eCOST to improve its financial and operating performance may result in a failure of eCOST to comply with its financial covenants

In the event eCOST is unable to increase its revenue and/or gross profit from its present levels and does not achieve the operating efficiencies targeted to occur upon completion of its integration into the Company s infrastructure, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and payment under the Company parent guaranty

If eCOST fails to accurately predict its inventory risk, its margins may decline as a result of write-downs of its inventory due to lower prices obtained from older or obsolete products.

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

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

eCOST makes allowances for product returns in its financial statements based on historical return rates. eCOST is responsible for returns of certain products ordered through its website from its distribution center as well as products that are shipped to its customers directly from its vendors. If eCOST s actual product returns significantly exceed its allowances for returns, especially as eCOST expands into new product categories, its revenues and profitability could decrease. In addition, because eCOST s allowances are based on historical return rates, the introduction of new merchandise categories, new products, changes in its product mix, or other factors may cause actual returns to exceed return allowances, perhaps significantly. In addition, any policies intended to reduce the number of product returns may result in customer dissatisfaction and fewer repeat customers.

eCOST s ability to offer a broad selection of products at competitive prices is dependent on its ability to maintain existing and build new relationships with manufacturers and vendors. eCOST does not have long-term agreements with its manufacturers or vendors and some of its manufacturers and vendors compete directly with eCOST.

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

eCOST s revenue is dependent in part on sales of HP and HP-related products, which represented 31% of eCOST s net sales for the six months ended June 30, 2006.

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

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

Because eCOST experiences seasonal fluctuations in its revenues, its quarterly results may fluctuate.

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

eCOST s business may be harmed by fraudulent activities on its website.

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

eCOST s business could be subject to political, economic and other risks associated with the Philippines.

To reduce costs, eCOST is evaluating shifting certain of its operations to the Philippines, which would subject eCOST to political, economic and other uncertainties, including expropriation, nationalization, renegotiation, or nullification of existing contracts, currency exchange restrictions and international monetary fluctuations. Furthermore, the Philippines has experienced violence related to guerrilla activity.

Delivery of eCOST s products could be delayed or disrupted by factors beyond its control, and it could lose customers as a result.

eCOST relies upon third party carriers for timely delivery of its product shipments. As a result, eCOST is subject to carrier disruptions and increased costs due to factors that are beyond its control, including employee strikes, inclement weather and increased fuel costs. Any failure to deliver products to customers in a timely and accurate manner may damage eCOST s reputation and brand and could cause it to lose customers. eCOST does not have a written long-term agreement with any of these third party carriers, and it cannot be sure that these relationships will continue on terms favorable to eCOST, if at all. If eCOST s

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relationship with any of these third party carriers is terminated or impaired or if any of these third parties is unable to deliver products, eCOST would be required to use alternative carriers for the shipment of products to customers. eCOST may be unable to engage alternative carriers on a timely basis or on favorable terms, if at all. Potential adverse consequences include:

reduced visibility of order status and package tracking;

delays in order processing and product delivery;

increased cost of delivery, resulting in reduced margins; and

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

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

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

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

eCOST has generated the substantial majority of its revenues during the past five years from the sale of computer hardware, software and accessories and consumer electronics products. In the past 18 months eCOST launched several new product categories, including digital imaging, watches and jewelry, housewares, DVD movies, video games, travel, bed and bath, apparel and accessories, licensed sports gear and cellular/wireless. While its merchandising platform has been incorporated into and tested in the online computer and consumer electronics retail markets, eCOST cannot predict with certainty whether it can be successfully applied to other product categories. In addition, expansion of its business strategy into new product categories may require eCOST to incur significant marketing expenses, develop relationships with new vendors and comply with new regulations. eCOST may lack the necessary expertise in a new product category to realize the expected benefits of that new category. These requirements could strain managerial, financial and operational resources. Additional challenges that may affect eCOST s ability to expand into new product categories include its ability to:

establish or increase awareness of new brands and product categories;

acquire, attract and retain customers at a reasonable cost;

achieve and maintain a critical mass of customers and orders across all product categories;

attract a sufficient number of new customers to whom new product categories are targeted;

successfully market new product offerings to existing customers;

maintain or improve gross margins and fulfillment costs;

attract and retain vendors to provide an expanded line of products to customers on terms that are acceptable; and

manage inventory in new product categories.

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

If eCOST is unable to provide satisfactory customer service, it could lose customers.

eCOST s ability to provide satisfactory levels of customer service depends, to a large degree, on the efficient and uninterrupted operation of its customer service operations. Any material disruption or slowdown in its order processing systems resulting from labor disputes, telephone or Internet failures, power or service outages, natural disasters or other events could make it difficult or impossible to provide adequate customer service and support. If eCOST is unable to continually provide adequate staffing and training for its customer service operations, its reputation could be seriously harmed and eCOST could lose customers. Because eCOST s success depends in large part on keeping its customers satisfied, any failure to provide high levels of customer service would likely impair its reputation and decrease its revenues.

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

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

- other multi-category online retailers such as Amazon.com and Buy.com;
- online discount retailers of computer and consumer electronics merchandise such as Computers4Sure, NewEgg and TigerDirect;
- liquidation e-tailers such as Overstock.com and SmartBargains.com;
- consumer electronics and office supply superstores such as Best Buy, Circuit City, CompUSA, Office Depot, OfficeMax and Staples; and
- manufacturers such as Apple, Dell, Gateway, Hewlett-Packard and IBM, that sell directly to customers.

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

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

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

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

Effective trademark, service mark, patent, copyright and trade secret protection may not be available in every country in which eCOST will sell its products and offer its services. In addition, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. Therefore, eCOST may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon or otherwise decrease the value of its trademarks and other proprietary rights. If eCOST is unable to protect or preserve the value of its trademarks, copyrights, trade secrets or other proprietary rights for any reason, eCOST s competitive position could be negatively affected and it could lose customers.

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

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

Third parties have asserted, and may in the future assert, that eCOST s business or the technologies it uses infringe on their intellectual property rights. As a result, eCOST may be subject to intellectual property legal proceedings and claims in the ordinary course of business. eCOST cannot predict whether third parties will assert additional claims of infringement in the future or whether any future claims will prevent it from offering popular products or services.

If eCOST is forced to defend against third-party infringement claims, whether they are with or without merit or are determined in its favor, eCOST could face expensive and time-consuming litigation, which could result in the imposition of a preliminary injunction preventing it from continuing to operate its business as currently conducted throughout the duration of the litigation or distract eCOST s technical and management personnel. If eCOST is found to infringe, it may be required to pay monetary damages, which could include treble damages and attorneys fees for any infringement that is found to be willful, and either be enjoined or required to pay ongoing royalties with respect to any technologies found to infringe. Further, as a result of infringement claims either against eCOST or against those who license technology to eCOST, eCOST may be required, or deem it advisable, to develop non-infringing technology, which could be costly and time consuming, or enter into costly royalty or licensing agreements. Such royalty or licensing agreements, if required, may be unavailable on terms that are acceptable, or at all. eCOST expects that participants in its market will be increasingly subject to infringement claims as the number of competitors in the industry grows. If a third party successfully asserts an infringement claim against eCOST and it is enjoined or required to pay monetary damages or royalties or eCOST is unable to develop suitable non-infringing alternatives or license the infringed or similar technology on reasonable terms on a timely basis, eCOST s business, results of operations and financial condition could be materially harmed.

eCOST may be liable for misappropriation of its customers personal information.

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

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

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

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

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

Risks Related to eCOST s Industry

eCOST s success is tied to the continued use of the Internet and the adequacy of the Internet infrastructure.

eCOST s future revenues and profits, if any, substantially depend upon the continued widespread use of the Internet as an effective medium of business and communication. If use of the Internet declines or the Internet infrastructure becomes an ineffective medium for business transactions and communication, eCOST may not be able to effectively implement its growth strategy and it could lose customers. Widespread use of the Internet could decline as a result of disruptions, computer viruses or other damage to Internet servers or users computers. Additionally, if the Internet s infrastructure does not expand fast enough to meet increasing levels of use, it may become a less effective medium of business transactions and communications.

The security risks of e-commerce may discourage customers from purchasing goods over the Internet.

In order for the e-commerce market to develop successfully, eCOST and other market participants must be able to transmit confidential information securely over public networks. Third parties may have the technology or know-how to breach the security of customer transaction data. Any breach could cause customers to lose confidence in the security of eCOST s website and choose not to purchase from the website. If someone is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt operations. Concerns about the security and privacy of transactions over the Internet could inhibit the growth of the Internet and e-commerce. Security measures may not effectively prohibit others from obtaining improper access to information. Any security breach could expose eCOST to risks of loss, litigation and liability and could seriously disrupt its operations.

Credit card fraud could decrease eCOST s revenues and profitability.

eCOST does not currently carry insurance against the risk of credit card fraud, so the failure to adequately control fraudulent credit card transactions could reduce its revenues and gross margin. ECOST has and may in the future suffer losses as a result of orders placed with fraudulent credit card data even though the associated financial institution approved payment of the orders. Under current credit card practices, eCOST may be liable for fraudulent credit card transactions because it did not obtain a cardholder s signature. If eCOST is unable to detect or control credit card fraud, or if credit card companies require more burdensome terms or refuse to accept credit card charges, eCOST s revenues and profitability could decrease.

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

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

Existing or future government regulation could expose eCOST to liabilities and costly changes in its business operations, and could reduce customer demand for its products.

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

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

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

ITEM 2. Changes in Securities and Use of Proceeds

None

ITEM 3. Defaults Upon Senior Securities

None

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

On June 9, 2006, the Company held it s Annual Meeting of Stockholders. The following matters were acted upon and votes cast or withheld:

1. Election of Directors:

David Beatson	For: 33,826,929	Withheld: 743,814
James Reilly	For: 33,806,799	Withheld: 763,944

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

For: 31,298,996	Against: 6,730,438	Abstentions: 147,713

3. Appointment of KPMG LLP as auditors for the fiscal year ending December 31, 2006:

For: 37,505,953	Against: 581,540	Abstentions: 99,654	No Vote: 348,806

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ITEM 5. Other Information

None.

ITEM 6. Exhibits

a) Exhibits:

Exhibit No.	Description of Exhibits
3.1(1)	Amended and Restated Certificate of Incorporation
3.2(1)	Amended and Restated Bylaws
4.1(2)	Purchase Agreement dated as of June 1, 2006 between PFSweb, Inc. and the Purchasers named therein.
4.2(2)	Registration Rights Agreement dated as of June 1, 2006 between PFSweb, Inc. and the Investors named therein.
31.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

(2) Incorporated by reference to Form 8-K filed on June 2, 2006.

* Filed herewith

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SIGNATURES

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

Date: August 14, 2006

PFSweb, Inc.

By: /s/ Thomas J. Madden

Thomas J. Madden
Chief Financial Officer,
Chief Accounting Officer,
Executive Vice President

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