

OVERSTOCK.COM, INC  
Form 10-Q  
November 07, 2007

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-49799

## OVERSTOCK.COM, INC.

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**87-0634302**  
(I.R.S. Employer  
Identification Number)

**6350 South 3000 East**

**Salt Lake City, Utah 84121**

(Address, including zip code, of

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Registrant's principal executive offices)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

There were 23,805,937 shares of the Registrant's common stock, par value \$0.0001, outstanding on November 2, 2007.

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## PART 1. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## Overstock.com, Inc.

## Consolidated Balance Sheets (unaudited)

(in thousands)

	December 31, 2006	September 30, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 126,965	\$ 74,145
Marketable securities		16,842
Total cash and marketable securities	126,965	90,987
Accounts receivable, net	11,638	7,607
Notes receivable	6,702	1,506
Inventories, net	20,274	22,400
Prepaid inventory	2,241	5,003
Prepaid expense	7,473	10,257
Current assets of held for sale subsidiary	4,718	
Total current assets	180,011	137,760
Property and equipment, net	56,198	33,450
Goodwill	2,784	2,784
Other long-term assets, net	578	197
Notes receivable (Note 4)		4,045
Long-term assets of held for sale subsidiary	16,594	
Total assets	\$ 256,165	\$ 178,236
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 66,039	\$ 38,504
Accrued liabilities	40,142	26,499
Capital lease obligations, current	5,074	3,801
Current liabilities of held for sale subsidiary	3,684	
Total current liabilities	114,939	68,804
Capital lease obligations, non-current	3,983	
Other long-term liabilities		3,113
Convertible senior notes	75,279	75,537
Total liabilities	194,201	147,454
Commitments and contingencies (Notes 12 and 13)		
Stockholders equity:		
Preferred stock, \$0.0001 par value, 5,000 shares authorized, no shares issued and outstanding as of December 31, 2006 and September 30, 2007		
Common stock, \$0.0001 par value, 100,000 shares authorized, 25,069 and 25,390 shares issued as of December 31, 2006 and September 30, 2007, respectively	2	2
Additional paid-in capital	325,771	332,899
Accumulated deficit	(198,694)	(238,549)
Treasury stock, 1,654 and 1,609 shares at cost as of December 31, 2006 and September 30, 2007, respectively	(64,983)	(63,435)

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Accumulated other comprehensive loss	(132)	(135)
Total stockholders' equity	61,964	30,782
Total liabilities and stockholders' equity	\$ 256,165	\$ 178,236

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

## Overstock.com, Inc.

## Consolidated Statements of Operations (unaudited)

(in thousands, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
Revenue				
Direct	\$ 56,564	\$ 39,446	\$ 205,044	\$ 128,725
Fulfillment partner	100,321	122,484	289,077	340,102
Total revenue	156,885	161,930	494,121	468,827
Cost of goods sold:				
Direct (1)	51,037	33,160	183,213	108,801
Fulfillment partner	84,483	100,509	243,481	280,147
Total cost of goods sold	135,520	133,669	426,694	388,948
Gross profit	21,365	28,261	67,427	79,879
Operating expenses:				
Sales and marketing (1)	17,282	8,835	41,852	28,081
Technology (1)	16,157	14,576	44,478	44,786
General and administrative (1)	11,078	9,724	33,978	30,842
Restructuring				12,283
Total operating expenses	44,517	33,135	120,308	115,992
Operating loss	(23,152)	(4,874)	(52,881)	(36,113)
Interest income	459	1,291	2,989	3,359
Interest expense	(1,096)	(1,029)	(3,638)	(3,085)
Other income, net	(6)	(92)	(7)	(92)
Loss from continuing operations	(23,795)	(4,704)	(53,537)	(35,931)
Loss from discontinued operations	(708)		(2,615)	(3,924)
Net loss	(24,503)	(4,704)	(56,152)	(39,855)
Deemed dividend related to redeemable common stock	(33)		(99)	
Net loss attributable to common shares	\$ (24,536)	\$ (4,704)	\$ (56,251)	\$ (39,855)
Net loss per common share basic and diluted:				
Loss from continuing operations	\$ (1.16)	\$ (0.20)	\$ (2.71)	\$ (1.52)
Loss from discontinued operations	\$ (0.03)	\$	\$ (0.13)	\$ (0.16)
Net loss per common share basic and diluted	\$ (1.19)	\$ (0.20)	\$ (2.84)	\$ (1.68)
Weighted average common shares outstanding basic and diluted	20,600	23,726	19,774	23,671

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

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Cost of goods sold direct	\$	103	\$	117	\$	308	\$	338
Sales and marketing	\$	77	\$	85	\$	225	\$	248
Technology	\$	173	\$	195	\$	513	\$	560
General and administrative	\$	689	\$	779	\$	2,042	\$	2,240

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

## Overstock.com, Inc.

## Consolidated Statements of Stockholders' Equity

## and Comprehensive Loss (unaudited)

(in thousands)

	Common stock		Additional Paid-in capital	Accumulated Deficit	Treasury stock		Accumulated Other Comprehensive Loss	Total
	Shares	Amount			Shares	Amount		
Balance at December 31, 2006	25,069	\$ 2	\$ 325,771	\$ (198,694)	(1,654)	\$ (64,983)	(132)	\$ 61,964
Exercise of stock options	321		2,182					2,182
Treasury stock issued to employees as compensation			(620)		45	1,548		928
Stock-based compensation from employee options			3,386					3,386
Stock-based compensation to consultants in exchange for services			280					280
Stock-based compensation related to performance shares			1,900					1,900
Comprehensive loss:								
Net loss				(39,855)				(39,855)
Net unrealized gain on marketable securities							2	2
Cumulative translation adjustment							(5)	(5)
Total comprehensive loss								(39,858)
Balance at September 30, 2007	25,390	\$ 2	\$ 332,899	\$ (238,549)	(1,609)	\$ (63,435)	(135)	\$ 30,782

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



## Overstock.com, Inc.

## Consolidated Statements of Cash Flows (unaudited)

(in thousands)

	Three months ended September 30,		Nine months ended September 30,		Twelve months ended September 30,	
	2006	2007	2006	2007	2006	2007
<b>Cash flows from operating activities of continuing operations:</b>						
Net loss	\$ (24,503)	\$ (4,704)	\$ (56,152)	\$ (39,855)	\$ (62,435)	\$ (85,469)
Adjustments to reconcile net loss to cash provided by (used in) operating activities of continuing operations:						
Loss from discontinued operations	708		2,615	3,924	3,830	8,191
Depreciation and amortization	7,776	7,080	20,802	22,825	25,447	34,350
Realized gain from marketable securities			(2,085)		(1,095)	
Realized loss on disposition of property and equipment			599	1	2,056	1
Stock-based compensation	1,042	1,176	3,088	3,386	3,095	4,418
Stock-based compensation to consultants for services	(3)	140	31	280	(20)	272
Stock-based compensation relating to performance shares		350		350		350
Treasury stock issued to employees as compensation	67	213	679	928	720	1,036
Amortization of debt discount and deferred financing fees	139	86	417	258	435	258
Restructuring				12,283		17,957
Gain from retirement of convertible senior notes					(1,988)	
Notes receivable accretion		(136)		(136)		(136)
Changes in operating assets and liabilities, net of effect of acquisition and discontinued operations:						
Accounts receivable, net	1,541	335	2,880	3,731	(461)	(1,201)
Inventories, net	6,040	(6,975)	24,487	(2,126)	29,352	40,396
Prepaid inventory	(781)	(2,879)	5,605	(2,762)	8,578	(979)
Prepaid expenses	455	(1,522)	(716)	(2,784)	22	(1,064)
Other long-term assets, net	(123)	100	(105)	366	(1,821)	967
Accounts payable	11,745	4,960	(53,479)	(27,632)	(358)	(9,353)
Accrued liabilities	(3,339)	(566)	(26,908)	(18,680)	(25,837)	(3,689)
Other long-term liabilities		(114)		(114)		(114)
Net cash provided by (used in) operating activities of continuing operations	764	(2,456)	(78,242)	(45,757)	(20,480)	6,191
<b>Cash flows from investing activities of continuing operations:</b>						
Change in restricted cash			253		633	
Purchases marketable securities		(7,783)		(29,164)	(2,000)	(29,164)
Sales of marketable securities		8,924	56,756	12,324	76,280	12,324
Expenditures for property and equipment	(7,769)	(316)	(19,675)	(2,232)	(27,851)	(5,998)

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Proceeds from the sale property and equipment	1		1		1	
Proceeds from the sale of discontinued operations, net of cash transferred				9,892		9,892
Decrease in cash resulting from deconsolidation of variable interest entity						(102)
Payments received on note receivable	502			5,196		5,196
Expenditures for other long-term assets			(100)		(100)	
Net cash provided by (used in) investing activities of continuing operations	(7,768)	1,327	37,235	(3,984)	46,963	(7,852)
<b>Cash flows from financing activities of continuing operations:</b>						
Payments on capital lease obligations	(124)	(5)	(2,878)	(5,256)	(6,730)	(5,335)
Drawdown on line of credit	5,245		78,503	1,169	86,003	9,347
Payments on line of credit	(5,245)		(78,503)	(1,169)	(90,371)	(9,347)
Payments to retire convertible senior notes					(7,735)	
Proceeds from the issuance of common stock			25,000		25,000	39,406
Exercise of stock options	806	261	2,267	2,182	2,701	2,449
Net cash provided by (used in) financing activities of continuing operations	682	256	24,389	(3,074)	8,868	36,520
Effect of exchange rate changes on cash	40	(26)	11	(5)	(14)	18
Cash provided by (used in) operating activities discontinued operations	42		112	(204)	67	1,265
Cash used in investing activities of discontinued operations	(39)		(343)	(53)	(441)	(276)
Net increase (decrease) in cash and cash equivalents	(6,279)	(899)	(16,838)	(53,077)	39,963	35,866
Change in cash and cash equivalents from discontinued operations	(3)		231	257	374	(989)
Cash and cash equivalents, beginning of period	45,550	75,044	55,875	126,965	3,931	39,268
Cash and cash equivalents, end of period	\$ 39,268	\$ 74,145	\$ 39,268	\$ 74,145	\$ 39,268	\$ 74,145
<b>Supplemental disclosure of cash flow information:</b>						
Interest paid	192	142	2,001	2,378	4,540	4,054
<b>Supplemental disclosures of non-cash flow information:</b>						
Deemed dividend on redeemable common shares	33		99		144	33
Lapse of rescission rights	2,431		3,304		3,450	
Equipment and software acquired under capital leases			2,274		2,322	

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

**Overstock.com, Inc.**

**Notes to Unaudited Consolidated Financial Statements**

**1. BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements have been prepared by Overstock.com, Inc. (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the audited annual consolidated financial statements and related notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2006. The accompanying unaudited consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of results for the interim periods presented. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates. The results of operations for the three and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

**2. ACCOUNTING POLICIES**

*Principles of consolidation*

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The consolidated financial statements include the accounts of the Company's OTravel subsidiary through April 25, 2007 (Note 4). The consolidated financial statements also include the accounts of a variable interest entity for which the Company was the primary beneficiary through November 30, 2006. All significant intercompany account balances and transactions have been eliminated in consolidation.

*Use of estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Internal-Use Software and Website Development*

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

During the three months ended September 30, 2006 and 2007, the Company capitalized \$7.3 million and \$209,000, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$3.6 million and \$3.2 million for those respective periods. For the nine months ended September 30, 2006 and 2007, the Company capitalized \$19.3 million and \$1.7 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$9.9 million and \$10.3 million for those respective periods.

### *Advertising expense*

The Company recognizes advertising expenses in accordance with SOP 93-7, *Reporting on Advertising Costs*. As such, the Company expenses the costs of producing advertisements at the time production occurs or the first time the advertising takes place and expenses the cost of communicating advertising in the period during which the advertising space or airtime is used. Internet advertising expenses are recognized as incurred based on the terms of the individual agreements, which are generally: 1) a commission for traffic driven to the Website that generates a sale 2) based on the number of clicks on keywords or links to our Website generated during a given period. Advertising expense included in sales and marketing expenses totaled \$17.1 million and \$7.8 million during the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, advertising expenses totaled \$41.1 million and \$25.5 million, respectively.

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*Stock-based Compensation*

As of January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) 123(R) *Share-based Payment – an Amendment of FASB Statements No 123 and 95*, which requires the Company to measure compensation expense for all outstanding unvested share-based awards at fair value and recognize compensation expense over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from estimates, such amounts will be recorded as an adjustment in the period estimates are revised. Management considers many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates.

*Recent accounting pronouncements*

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

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

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of a full valuation allowance, the Company does not have any unrecognized tax benefits and there is no effect on its financial condition or results of operations as a result of implementing FIN 48. The Company is subject to audit by the IRS and various states for the prior 3 years. The Company does not believe there will be any material changes in its unrecognized tax positions over the next 12 months. The Company's policy is that it recognizes interest and penalties accrued on any unrecognized tax positions as a component of income tax expense. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax positions, nor was any interest expense recognized during the three or nine months ended September 30, 2007.

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

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

*Reclassifications*

Certain prior period amounts have been reclassified to conform to the current period's presentation. In addition, the Company has revised its consolidated statements of operations and consolidated statements of cash flows for the three and nine months ended September 30, 2006 to present the loss from discontinued operations and the operating and investing portion of the cash flows attributable to discontinued operations on a separately identifiable basis. The effect of these reclassifications had no impact on net income, total assets, total liabilities, or stockholders equity.

**3. RESTRUCTURING EXPENSE**

During the fourth quarter of 2006, the Company commenced implementation of a facilities consolidation and restructuring program designed to reduce the overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program was substantially completed by the end of the second quarter of 2007. There were no restructuring expenses during the third quarter of 2007.

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

During the first nine months of 2007, the Company accrued \$8.0 million of restructuring charges related to the termination of a logistics services agreement, termination and settlement of a lease related to its vacated warehouse facilities in Indiana and

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abandonment and marketing for sub-lease office and data center space in the current corporate office facilities. During the second quarter of 2007, the Company reached an agreement to terminate the Indiana warehouse facilities lease effective August 15, 2007 for \$1.9 million, resulting in a reversal of restructuring expense of approximately \$1.0 million.

The Company also recorded an additional \$2.4 million of restructuring charges related to accelerated amortization of leasehold improvements located in the abandoned office and co-location data center space and \$2.0 million of other restructuring charges, primarily related to consolidation of office space in the current corporate office facilities, relocation of a data center and employee severance.

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

	Balance 12/31/2006	Charges to expense	Cash payment or accelerated amortization	Balance 9/30/2007
Lease and contract termination costs	\$ 5,499	\$ 9,424	\$ (10,139)	\$ 4,784
Asset retirement obligation	450		(450)	
Accelerated amortization of leasehold improvements		2,359	(2,359)	
Other restructuring expenses		500	(200)	300
<b>Total</b>	<b>\$ 5,949</b>	<b>\$ 12,283</b>	<b>\$ (13,148)</b>	<b>\$ 5,084</b>

#### 4. SALE OF DISCONTINUED OPERATIONS

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

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

During the fourth quarter of 2006, in conjunction with the facilities consolidation and restructuring program described in Note 3, management decided to sell OTravel. The Company evaluated its plan to sell OTravel in accordance with SFAS 144, which requires that long-lived assets be classified as held for sale only when certain criteria are met. The Company classified the OTravel assets and liabilities as held for sale as it met these criteria as of December 31, 2006, which include: management's commitment to a plan to sell the assets; availability of the assets for immediate sale in their present condition; an active program to locate buyers and other actions to sell the assets has been initiated; sale of the assets is probable and their transfer is expected to qualify for recognition as a completed sale within one year; assets are being marketed at reasonable prices in relation to their fair value; and unlikelihood that significant changes will be made to the plan to sell the assets. The travel business is not part of the Company's core business operations and is no longer part of its strategic focus. The results of operations for the subsidiary were included in the fulfillment partner segment prior to being classified as discontinued operations.

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

On April 25, 2007, the Company completed the sale of OTravel.com to Castles Travel, Inc., an affiliate of Kinderhook Industries, LLC, and Castles Media Company LLC, for \$17.0 million. The Company received cash proceeds, net of cash transferred, of \$9.9 million and two \$3.0 million promissory notes. The \$3.0 million senior note matures three years from the closing date and bears interest, payable quarterly, of 4.0%, 10.0% and 14.0% per year in the first, second and third years, respectively. The \$3.0 million junior note matures five years from the closing date and bears interest of 8.0% per year, compounded annually, and is payable in full at maturity.

The following table is a summary of the Company's discontinued operations for the nine months ended September 30, 2006 and the period ended April 25, 2007 (in thousands):

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	Nine months ended September 30, 2006		Year-to-date period ended April 25, 2007	
Sales	\$	4,780	\$	2,226
Cost of sales		(1,103)		(650)
Gross profit		3,677		1,576
Sales and marketing		(1,312)		(447)
Technology		(377)		(60)
General and administrative		(4,603)		(1,152)
Goodwill impairment				(3,841)
Loss from discontinued operations	\$	(2,615)	\$	(3,924)

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

	December 31, 2006	
Assets of held for sale subsidiary:		
Cash	\$	1,365
Accounts receivable		3,267
Property and equipment, net		1,215
Goodwill and intangible assets, net		15,379
Other		86
Total assets of discontinued operations	\$	21,312
Liabilities of held for sale subsidiary:		
Current liabilities:		
Accounts payable	\$	2,947
Accrued liabilities		737
Total liabilities of discontinued operations	\$	3,684

## 5. MARKETABLE SECURITIES

The Company's marketable securities consist of funds deposited into a capital management account managed by a financial institution at September 30, 2007 as follows:

	Amortized Cost Basis		Unrealized Gains		Unrealized Losses		Fair Value	
Corporate debt securities	\$	16,840	\$	2	\$	\$	16,842	

All marketable securities mature in 2007 and are classified as available-for-sale securities. Available-for-sale securities are classified as current as they are deemed available for use. There were no marketable securities at December 31, 2006.

### *Derivative instruments*

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

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

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

On April 26, 2006, the Company sold the Foreign Notes for \$49.5 million resulting in a gain of \$1.9 million, which the Company recognized in the second quarter of 2006 as a component of interest income. The Company had previously recorded \$2.4 million of accumulated unrealized losses as a component of interest income over the period the Foreign Notes had been held.

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**6. OTHER COMPREHENSIVE LOSS**

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2007	2006	2007
Net loss	\$ (24,503)	\$ (4,704)	\$ (56,152)	\$ (39,855)
Net unrealized gain on marketable securities		1		2
Unrealized gain on Foreign Notes			740	
Reclassification adjustment for gains included in net loss			(1,868)	
Foreign currency translation adjustment	40	(26)	11	(5)
Comprehensive loss	\$ (24,463)	\$ (4,729)	\$ (57,269)	\$ (39,858)

**7. EARNINGS (LOSS) PER SHARE**

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

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2007	2006	2007
Loss from continuing operations	\$ (23,795)	\$ (4,704)	\$ (53,537)	\$ (35,931)
Deemed dividend related to redeemable common stock	(33)		(99)	
Loss from continuing operations attributable to common shares	(23,828)	(4,704)	(53,636)	(35,931)
Loss from discontinued operations	(708)		(2,615)	(3,924)
Net loss attributable to common shares	\$ (24,536)	\$ (4,704)	\$ (56,251)	\$ (39,855)
Weighted average common shares outstanding basic	20,600	23,726	19,774	23,671
Effective of dilutive securities:				
Stock options				
Convertible senior notes				
Weighted average common shares outstanding diluted	20,600	23,726	19,774	23,671

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Net loss per common share basic and diluted:					
Loss from continuing operations	\$	(1.16)	\$	(0.20)	\$ (2.71) \$ (1.52)
Loss from discontinued operations	\$	(0.03)	\$		\$ (0.13) \$ (0.16)
Net loss per common share basic and diluted	\$	(1.19)	\$	(0.20)	\$ (2.84) \$ (1.68)

The stock options, warrants and convertible senior notes outstanding were not included in the computation of diluted earnings per share because to do so would have been antidilutive. The number of stock options outstanding at September 30, 2006 and 2007 was 1,093,000 and 1,176,000, respectively. As of September 30, 2007, the Company had \$77.0 million of convertible senior notes outstanding, which could potentially convert into 1,010,000 shares of common stock in the aggregate.

**8. BUSINESS SEGMENTS**

Segment information has been prepared in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Segments were determined based on products and services provided by each segment. There were no inter-segment sales or transfers during the three and nine months ended September 30, 2006 or 2007. The Company evaluates the performance of its segments and allocates resources to them based primarily on gross profit. The table below summarizes information about reportable segments for the three and nine months ended September 30, 2006 and 2007 (in thousands):

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	Three months ended September 30, Fulfillment			Nine months ended September 30, Fulfillment		
	Direct	partner	Consolidated	Direct	partner	Consolidated
<b>2006</b>						
Revenue	\$ 56,564	\$ 100,321	\$ 156,885	\$ 205,044	\$ 289,077	\$ 494,121
Cost of goods sold	51,037	84,483	135,520	183,213	243,481	426,694
Gross profit	\$ 5,527	\$ 15,838	21,365	\$ 21,831	\$ 45,596	67,427
Operating expenses			(44,517)			(120,308)
Other income (expense), net			(643)			(656)
Loss from continuing operations			\$ (23,795)			\$ (53,537)
<b>2007</b>						
Revenue	\$ 39,446	\$ 122,484	\$ 161,930	\$ 128,725	\$ 340,102	\$ 468,827
Cost of goods sold	33,160	100,509	133,669	108,801	280,147	388,948
Gross profit	\$ 6,286	\$ 21,975	28,261	\$ 19,924	\$ 59,955	79,879
Operating expenses			(33,135)			(115,992)
Other income (expense), net			170			182
Loss from continuing operations			\$ (4,704)			\$ (35,931)

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

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

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

For the three and nine months ended September 30, 2006 and 2007, over 99% of sales were made to customers in the United States of America. No individual geographical area within the U.S accounted for more than 10% of net sales in any of the periods presented. At December 31, 2006 and September 30, 2007, all of the Company's fixed assets were located in the United States of America.

## 9. PERFORMANCE SHARE PLAN

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

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of the Company's common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan were originally payable in cash. During interim and annual periods prior to the third quarter of 2007, the Company recorded compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates included assumed future growth rates in revenues, gross margins and other factors. If the Company were to use different assumptions, the estimated compensation charges could be significantly different.

An amendment to the Performance Share Plan to allow the Company to make payments in the form of common stock was approved by the shareholders on May 15, 2007. In the third quarter of 2007, the Company engaged an independent third party valuation group to determine the fair value of the awards on the amendment date. Based on the independent third party valuation, the Company made the determination on August 7, 2007 to make the payments in the form of common stock, rather than cash. Therefore, the Company reclassified from their current status as liability awards to equity awards in accordance with FAS 123(R).

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The Company reclassified a liability of approximately \$1.5 million related to performance share awards granted prior to the determination to additional-paid-in-capital and recognized additional compensation of approximately \$350,000 of compensation expense under the plan in general and administrative expenses for the quarter ended September 30, 2007, based on changes in the Company's estimates regarding the ultimate growth in economic value expected to occur. During the quarter ended September 30, 2006, compensation expense under the Plan was reduced by \$100,000. For the nine months ended September 30, 2006 and 2007, compensation expense under the plan totaled \$800,000 and \$1.0 million, respectively. As of September 30, 2007, the Company has recognized \$1.9 million in total compensation expense under the plan.

## 10. BORROWINGS

### \$30.0 million Amended Credit Agreement

On October 18, 2005, the Company entered into a sixth amendment to a credit agreement ( Amended Credit Agreement ) with Wells Fargo Bank, N.A. The Amended Credit Agreement provides a revolving line of credit to the Company of up to \$30.0 million which the Company uses primarily to obtain letters of credit to support inventory purchases. The Amended Credit Agreement expires on December 31, 2007; however, the Company has an option to renew the Amended Credit Agreement annually. Interest on borrowings is payable monthly and accrued at either (i) 1.35% above LIBOR in effect on the first day of an applicable fixed rate term, or (ii) at a fluctuating rate per annum determined by the bank to be one half a percent (0.50%) above daily LIBOR in effect on each business day a change in daily LIBOR is announced by the bank. Unpaid principal, together with accrued and unpaid interest, is due on the maturity date. The Amended Credit Agreement requires the Company to comply with certain covenants, including restrictions on mergers, business combinations or transfer of assets. The Company was in compliance with these covenants at September 30, 2007.

Borrowings and outstanding letters of credit under the Amended Credit Agreement are required to be completely collateralized by cash balances held at Wells Fargo Bank, N.A, and therefore the facility does not provide additional liquidity to the Company.

At September 30, 2007, no amounts were outstanding under the Amended Credit Agreement, and Letters of Credit totaling \$2.7 million were issued on behalf of the Company.

### \$40.0 million WFRF Agreement

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

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

Advances under the WFRF Agreement bear interest at either (a) the rate announced, from time to time, within Wells Fargo Bank, N.A. at its principal office in San Francisco as its prime rate or (b) a rate based on LIBOR plus a varying percentage between 1.25% and 1.75%; however, the annual interest rate on advances under the WFRF Agreement will be at least 3.50%. The WFRF Agreement includes affirmative covenants as well as negative covenants that prohibit a variety of actions without the lender's approval, including covenants that limit the Company's ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another person, (d) sell assets, (e) change its name or the name of any of its subsidiaries, (f) make certain changes to its business, (g) optionally prepay, acquire or refinance indebtedness, (h) consign inventory, (i) pay dividends on, or purchase, acquire or redeem shares of, its capital stock, (j) change its method of accounting, (k) make investments, (l) enter into transactions with affiliates, or (m) store any of its inventory or equipment with third parties. The Company was in compliance with these covenants as of September 30, 2007. At September 30, 2007, no amounts were outstanding and availability under the WFRF Agreement was \$8.8 million.

Capital leases

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

Software and equipment relating to the capital leases totaled \$19.8 million at December 31, 2006 and September 30, 2007, with accumulated amortization of \$12.4 million and \$17.4 million at those respective dates.

Depreciation of assets recorded under capital leases was \$1.8 million and \$1.6 million for the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, depreciation of assets recorded under

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capital leases was \$5.4 million and \$4.9 million, respectively.

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

<b>Twelve months ending September 30,</b>		
2008	\$	4,091
Less: amount representing interest		(290)
Present value of capital lease obligations		3,801
Less: current portion		(3,801)
Capital lease obligations, non-current	\$	

### 11. 3.75% CONVERTIBLE SENIOR NOTES

In November 2004, the Company completed an offering of \$120.0 million of 3.75% Convertible Senior Notes (the Senior Notes). Proceeds to the Company were \$116.2 million, net of \$3.8 million of initial purchaser's discount and debt issuance costs. The discount and debt issuance costs are being amortized using the straight-line method which approximates the interest method. The Company recorded amortization of discount and debt issuance costs related to this offering totaling \$139,000 and \$86,000 during the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, amortization of discount and debt issuance costs totaled \$417,000 and \$258,000, respectively. Interest on the Senior Notes is payable semi-annually on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2011 and are unsecured and rank equally in right of payment with all existing and future unsecured, unsubordinated debt and senior in right of payment to any existing and future subordinated indebtedness.

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

The indenture governing the Senior Notes requires the Company to comply with certain affirmative covenants, including making principal and interest payments when due, maintaining the Company's corporate existence and properties, and paying taxes and other claims in a timely manner. The Company was in compliance with these covenants at September 30, 2007.

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

## 12. COMMITMENTS AND CONTINGENCIES

### *Commitments*

#### Corporate office space

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

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

During the fourth quarter 2006, the Company commenced implementation of a facilities consolidation and restructuring program. The Company recorded a liability of \$450,000 for the costs to dismantle and dispose of an escalator system and to return the leased facilities to their original condition under the Tenant Improvement Agreement and incurred additional amortization expense in connection with the revised useful life of certain leasehold improvements. In the second quarter of 2007, the Company abandoned and began marketing for sub-lease office and data center space in the current corporate office facilities and recorded an additional \$2.4 million of restructuring charges related to accelerated amortization of leasehold improvements located in the abandoned office and data center space and \$2.0 million of other restructuring charges, primarily related to consolidation of office

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space in the current corporate office facilities, relocation of a data center and employee severance (see Note 3).

#### Logistics and warehouse space

In July 2004, the Company entered into a logistics service agreement (the Logistics Agreement ) wherein the handling, storage and distribution of some of the Company's prepackaged products is performed by a third party. The Logistics Agreement and subsequent amendment set forth terms on which the Company paid various fixed fees based on square feet of storage and various variable costs based on product handling costs for a term of five years.

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

In the first quarter of 2007, the Company terminated the Logistics Agreement and gave notice of intent to sublease the Indiana warehouse facilities under the License Agreement. During the second quarter of 2007, the Company reached an agreement to terminate the Indiana warehouse facilities lease effective August 15, 2007 for \$1.9 million (see Note 3).

The Company leases 561,000 square feet for its warehouse facilities in Utah under operating leases which expire in August 2012. The Company has also temporarily leased an additional 251,000 square feet of warehouse space in Utah under operating leases for the seasonal increase in inventory during the fourth quarter of 2007.

#### Co-location data center

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

In December 2006, the Company entered into a Co-location Data Center Agreement (the OM I Co-location Agreement ) to lease 3,999 square feet of space at Old Mill Corporate Center I for an IT co-location data center to allow the Company to consolidate other IT data center facilities at the Old Mill Corporate Center II and at the Company's current corporate offices facilities.

#### Operating leases

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

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

<b>Twelve months Ending September 30,</b>	
2008	\$ 8,422
2009	6,228
2010	6,117
2011	5,764
2012	5,812
Thereafter	12,261
	\$ 44,604

Rental expense for operating leases totaled \$4.3 million and \$3.2 million for the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, rental expense totaled \$7.3 million and \$6.9 million, respectively.

### ***Redeemable Common Stock***

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

### ***Legal Proceedings***

From time to time, the Company receives claims of and become subject to consumer protection, employment, intellectual

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

On August 11, 2005, along with a shareholder plaintiff, the Company filed a complaint against Gradient Analytics, Inc.; Rocker Partners, LP; Rocker Management, LLC; Rocker Offshore Management Company, Inc. and their respective principals in the Superior Court of California, County of Marin. On October 12, 2005, the Company filed an amended complaint against the same entities alleging libel, intentional interference with prospective economic advantage and violations of California's unfair business practices act. On March 7, 2006, the court denied the defendants demurrers to and motions to strike the amended complaint. The defendants each filed a motion to appeal the court's decision, the Company responded and the California Attorney General submitted an amicus brief supporting the Company's view; the court has ruled that this appeal stays discovery in the case. On May 30, 2007 the California Court of Appeals upheld the lower court's ruling in the Company's favor. Defendants filed motions for rehearing, which the Court of Appeals summarily denied on June 27, 2007. Defendants have filed Petitions for Review before the California Supreme Court which the California Supreme court denied on September 19, 2007. On October 1, 2007, the Court of Appeals remitted the case back to the Superior Court. The parties have begun discovery in this case. The Company intends to continue to pursue this action vigorously.

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

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

On March 29, 2007, the Company, along with other defendants, was sued in United States District Court for the Eastern District of Texas, Tyler Division, by Orion IP, LLC. The suit alleges that the Company and the other defendants infringe two patents owned by Orion that relate to the

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making and using supply chain methods, sales methods, sales systems, marketing methods, marketing systems, and inventory systems. On April 30, 2007, the Company filed an answer denying Orion's allegations and a counterclaim asserting that Orion's patent is invalid. The case is in its initial stages. As it has consistently done with similar suits filed by patent trolls, the Company intends to vigorously defend this action.

On October 5, 2007 the Company was served as defendant in a case alleging violations of the Fair and Accurate Transaction Act (the Act). The plaintiff alleges that, because the Company followed an industry practice of displaying to the customer on a confirmation page the expiration date of the customer's credit card while the customer was online and logged into the customer's own account, the Company has violated certain provisions of the Act which prohibit a merchant from printing the credit card expiration date on a receipt. Filed in the U.S. District Court, Southern District of Illinois, the case is styled as a class action lawsuit on behalf of the nominative plaintiff and all others similarly situated. The case is in its preliminary stages. The Company believes it

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has substantial defenses to the suit, including that the law does not apply to the alleged facts, and intends to vigorously defend this action.

### **13. INDEMNIFICATIONS AND GUARANTEES**

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

### **14. STOCK OFFERINGS**

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

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

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

*These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially from management's expectations. For a discussion of some, but not all of these risks and uncertainties, please see Item 1A Risk Factors and the description of risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2006. These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.*

### Overview

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

Our company, based in Salt Lake City, Utah, was founded in 1997, and we launched our first Website through which customers could purchase products in March 1999. Our Website offers our customers an opportunity to shop for bargains conveniently, while offering our suppliers an alternative inventory liquidation distribution channel. We continually add new, limited inventory products to our Website in order to create an atmosphere that encourages customers to visit frequently and purchase products before our inventory sells out. We offer approximately 54,000 products under multiple stores under the shopping tab on our main Website, and offer almost 724,000 media products in the Entertainment store on our Website.

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



## **Our Business**

We utilize the Internet to create a more efficient market for liquidation, closeout and other discount merchandise. We provide consumers and businesses with quick and convenient access to high-quality, brand-name merchandise at discount prices. Our shopping business includes both a direct business and a fulfillment partner business. Products from our direct segment and fulfillment partner segments are also available in bulk to both consumers and businesses through the Wholesale product category on our Website. During the nine months ended September 30, 2007, no single customer accounted for more than 1% of our total revenue.

### *Direct business*

Our direct business includes sales made to individual consumers and businesses, which are fulfilled from our warehouses in Salt Lake City, Utah. During the nine months ended September 30, 2007, we fulfilled approximately 26% of all orders through our warehouses. Our warehouses generally ship between 5,000 and 8,000 orders per day and up to approximately 34,000 orders per day during peak periods, using overlapping daily shifts.

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*Fulfillment partner business*

For our fulfillment partner business, we sell merchandise of other retailers, cataloguers or manufacturers ( fulfillment partners ) through our Website. We are considered to be the primary obligor for the majority of these sales transactions and we assume the risk of loss on returned items. As a consequence, we record revenue from the majority of these sales transactions involving our fulfillment partners on a gross basis. Our use of the term partner or fulfillment partner does not mean that we have formed any legal partnerships with any of our fulfillment partners. We currently have fulfillment partner relationships with approximately 580 third parties which post approximately 39,000 non-BMMG products, as well as most of the BMMG products on our Website.

Our revenue from sales on our shopping site from both the direct and fulfillment partner businesses is recorded net of returns, coupons and other discounts. During the third quarter, we updated our returns policy to one that we believe is more consistent with industry practices. For products other than computers, electronics and mattresses the returns policy provides for a full refund of the cost of the merchandise and all shipping charges if the item shipped is returned unopened within 30 days of delivery. If the item is returned after 30 days of delivery, opened or shows signs of wear, the transaction may only be subject to partial refund. For items shipped from our Computers and Electronics department, returns must be initiated within 20 days of the purchase date and must be received in the original condition within 30 days of purchase. Computer and Electronics items returned opened or received at our warehouse after 30 days may only qualify for up to a 70 percent refund. Damaged or defective mattresses qualify for a full refund only if the items are refused at the time of delivery.

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

*Wholesale business*

Our Wholesale store allows consumers and businesses to purchase selected products in bulk quantities. For this store, we sell products from similar product categories as our shopping tab, as well as products from various industry verticals, such as florist supplies, restaurant supplies, and office supplies.

*Auctions business*

We operate an online auction service as part of our Website. Our auction tab allows sellers to list items for sale, buyers to bid on items of interest, and users to browse through listed items online. We record only our listing fees and commissions for items sold as revenue. From time to time, we also sell items returned from our shopping site on our auction site, and for these sales, we record the revenue on a gross basis. Revenue from our auction business is included in the fulfillment partner segment, as it is not significant enough to segregate as its own segment.

*Car listing business*

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

### *Cost of goods sold*

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

### *Operating expenses*

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

Advertising expense is the largest component of our sales and marketing expenses and is primarily attributable to expenditures related to online marketing activities and offline national radio and television advertising. Our advertising expenses totaled approximately \$17.1 million and \$7.8 million for the three months ended September 30, 2006 and 2007, respectively, representing 99% and 89% of sales and marketing expenses for those respective periods. For the nine months ended September 30, 2006 and 2007, our advertising expense totaled approximately \$41.1 million and \$25.5 million, respectively, representing 98% and 91% of sales and marketing expenses for those respective periods.

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

General and administrative expenses consist of wages and benefits, including stock-based compensation, for executive, legal,

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accounting, merchandising and administrative personnel, rent and utilities, travel and entertainment, depreciation and amortization of intangible assets and other general corporate expenses.

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

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

### **Executive Commentary**

*Commentary Revenue and Marketing.* Our third quarter revenue increased 3% compared to the third quarter of 2006, and declined 5% for the nine months of 2007 compared to 2006. We believe we are making progress in our efforts to grow revenue, achieving positive incremental improvement over the past two quarters (from revenue shrinking 11% in the first quarter to revenue growth of 3% in the third quarter), even while significantly reducing the dollars spent on marketing (down 33% to \$28.1 million in the first nine months of 2007 from \$41.9 million in 2006). We have also spent marketing dollars more efficiently over the first nine months of 2007 (6.0% of sales versus 8.5% in 2006).

To further assist in our efforts to generate positive revenue growth, we continue to increase the number of products available on our Website both by increasing the number of items offered by existing fulfillment partners, and by adding new fulfillment partners to sell product on our site. In addition, early in the fourth quarter we launched a new television advertising campaign, and we recently decided to invest more heavily in television, radio and print advertising during the fourth quarter than in the first nine months of 2007 (we intend to spend an incremental \$5 million over the amount we had originally anticipated) to both strengthen our brand and enhance revenue growth.

*Commentary Gross Margins.* Although revenue only increased 3% in the third quarter, gross profit dollars increased 32% to \$28.3 million. Gross margins were 17.5% in the third quarter, up 383 basis points over the third quarter of 2006. The gains in gross margins are primarily due to significant improvement in our direct margins, which are up 610 basis points year-over-year to 15.9%. We significantly reduced our inventory over the course of 2006 in an effort to refine the selection of products that we purchase directly to categories that turn faster and have higher profitability. We believe that we can run our direct business with significantly less inventory than we have had in the past, while filling in product selection using fulfillment partners, rather than acquiring the inventory directly. As a result of these efforts, we have seen a significant improvement in direct and overall gross margins in the first nine months of this year over the same period in 2006. With reduced inventory levels, we have also successfully reduced our warehouse space and the related costs, which we expect will assist in our efforts to further improve our direct gross margins. We also had a 210 basis point improvement in our fulfillment partner margins in the quarter from 15.8% in 2006 to 17.9%.

*Commentary Contribution and Contribution Margin.* Contribution (gross profit dollars less sales and marketing expense) increased \$15.3 million (or 376%) to \$19.4 million for the third quarter of 2007 versus \$4.1 million recorded during

the same quarter in 2006. This was due to the improvements we made in gross margins (up 383 basis points to 17.5%) combined with an \$8.4 million reduction in sales and marketing dollars spent. This equates to contribution margin of 12.0% versus 2.6% in 2006. For the nine months ended September 30, 2006 and 2007, contribution increased 103% or \$26.2 million to \$51.8 million from \$25.6 million, representing contribution margins of 5.2% and 11.0%, respectively, a 580 basis point improvement. The following table represents our calculation of contribution (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2007	2006	2007
Total revenue	\$ 156,885	\$ 161,930	\$ 494,121	\$ 468,827
Cost of goods sold	135,520	133,669	426,694	388,948
Gross profit	21,365	28,261	67,427	79,879
Less: Sales and marketing expense	17,282	8,835	41,852	28,081
Contribution	\$ 4,083	\$ 19,426	\$ 25,575	\$ 51,798
Contribution margin	2.6%	12.0%	5.2%	11.0%

*Commentary Technology and G&A costs.* We terminated a long-term computer co-location facility lease in December 2006 and we have reduced corporate headcount over the first nine months of 2007. We have also significantly reduced facilities costs and other expenses by reducing our corporate office space. As a result, our combined technology and G&A costs were down 11% or \$2.9 million in the third quarter of 2007 versus 2006.

Overall, our operating expenses were down 26% in the third quarter over the previous year, while revenue was up 3% and gross profit dollars were up 32%.

*Commentary Operating loss.* Our operating loss for the third quarter was \$4.9 million, down 79% from \$23.2 million in 2006. Over the first nine months of the year, our operating loss was \$36.1 million, down 32% from \$52.9 million over the same period last year. The 2007 operating loss includes \$12.3 million of restructuring costs (\$6.1 million in Q1 and \$6.2 million in Q2). Before restructuring costs, the operating loss was \$23.8 million for the nine months ended September 30, 2007, a \$29.1 million year-over-year improvement. Restructuring costs primarily represent our efforts to reduce our overall expense structure through the consolidation of our corporate office, data centers and warehouse facilities. Therefore, we believe that discussing our operating loss before restructuring costs (a non-GAAP measure) provides useful information to us and investors because it is a representation of the expense structure of the company if we had not originally incurred these costs. We use this measure to monitor our progress in reducing our overall expense structure, including the comparison of operating results in the current year to similar periods in the previous year. See the following table for operating loss before restructuring costs (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
Operating loss	\$ (23,152)	\$ (4,874)	\$ (52,881)	\$ (36,113)
Add back: restructuring				12,283
Operating loss before restructuring	\$ (23,152)	\$ (4,874)	\$ (52,881)	\$ (23,830)

#### *Non-GAAP Financial Measure*

Regulation G, *Conditions for Use of Non-GAAP Financial Measures, and other SEC regulations regulate the disclosure of certain non-GAAP financial information.* Our measure of EBITDA is a non-GAAP financial measure. EBITDA, which we reconcile to Operating loss in our income statement, is earnings before interest, taxes, depreciation, amortization and stock-based compensation. EBITDA is used in addition to and in conjunction with results presented in accordance with GAAP and should not be relied upon to the exclusion of GAAP financial measures. EBITDA reflects an additional way of viewing our results that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our results. You should review our financial statements and publicly-filed reports in their entirety and not rely on any single financial measure. Our discussion below (i) explains why management believes that presentation of EBITDA provides useful information to investors regarding our financial condition and results of operations, (ii) to the extent material, discloses the additional purposes, if any, for which management uses this non-GAAP measure, and (iii) provides a reconciliation of this measure to our operating losses.

*Commentary EBITDA (non-GAAP).* EBITDA for the third quarter of 2007 was \$4.1 million, an improvement from \$(14.4 million) in Q3 2006. For the first nine months of the year, EBITDA was \$(8.3 million), \$20.0 million better than the \$(28.3 million) in the previous year. We believe that, because our current capital expenditures are significantly lower than our depreciation levels, discussing EBITDA at this stage of our business is useful to us and investors. During 2005 and 2006, we made significant investments in our systems and overall infrastructure, and as a result will have approximately \$30 million of related depreciation expense in 2007. However, we expect to spend less than \$5 million in new capital expenditures during 2007, and therefore we use EBITDA as a reasonable measure of actual cash used or cash generated by the operations of the business.

For further details on EBITDA, see the reconciliation of this non-GAAP measure to our GAAP operating loss as follows (in thousands):

	Three months ended				Nine months ended			
	September 30,				September 30,			
	2006		2007		2006		2007	
Operating loss	\$	(23,152)	\$	(4,874)	\$	(52,881)	\$	(36,113)
Add: Depreciation and amortization		7,776		7,080		20,802		22,825
Stock-based compensation expense		1,042		1,176		3,088		3,386
Stock-based compensation to consultants for service		(3)		140		31		280
Stock-based compensation relating to performance shares				350				350
Treasury stock issued to employees as compensation		67		213		679		928
EBITDA	\$	(14,270)	\$	4,085	\$	(28,281)	\$	(8,344)

*Commentary Balance Sheet Items.* We ended the quarter with \$91.0 million in cash, cash equivalents and marketable securities, and generated trailing twelve months ( TTM ) \$6.2 cash flows from operations.

We ended the third quarter with \$22.4 million of inventory, significantly lower than the \$68.8 million of inventory we had at the end of the third quarter of 2006. During the quarter, we have been able to turn our inventory more efficiently (inventory turns increased from 3.9 times to 9.4 times) on much lower inventory levels, while maintaining more attractive, higher margin products.

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

### Critical Accounting Policies and Estimates

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

revenue recognition;

estimating valuation allowances and accrued liabilities (specifically, the reserve for returns, the allowance for doubtful accounts and the reserve for obsolete and damaged inventory);

internal use software;

accounting for income taxes;

valuation of long-lived and intangible assets and goodwill; and

stock based compensation and performance share plan.

*Revenue recognition.* We derive our revenue primarily from two sources: (i) direct revenue, which consists of merchandise sales made to consumers and businesses that are fulfilled from our warehouses; and (ii) fulfillment partner revenue, which consists of revenue from the sale of merchandise supplied and shipped by fulfillment partners directly to consumers and other businesses. Fulfillment partner revenue also includes listing fees and commissions collected from products being listed and sold through the Auctions tab of our Website as well as advertisement revenue derived from our cars listing business. All sources of revenue are recorded net of returns, coupons redeemed by customers, and other discounts. Revenues from our auction services and cars listing business were not material during the three and nine months ended September 30, 2006 and 2007, and therefore are included in fulfillment partner revenue.



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We record revenue from the majority of these sales transactions involving our fulfillment partners (excluding auctions) on a gross basis. Similar to our direct revenue segment, fulfillment partner products are available to both consumers and businesses.

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

*Reserve for returns, allowance for doubtful accounts and the reserve for obsolete and damaged inventory.* Our management must make estimates of potential future product returns related to current period revenue. Management analyzes historical returns, current economic trends and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns reserve and other allowances in any accounting period. The reserve for returns was \$3.6 million and \$2.1 million as of December 31, 2006 and September 30, 2007, respectively.

From time to time, we grant credit to certain of our business customers on normal credit terms (typically 30 days). We perform ongoing credit evaluations of our customers' financial condition and maintain an allowance for doubtful accounts receivable based upon our historical collection experience and expected collectibility of all accounts receivable. We maintained an allowance for doubtful accounts receivable of \$2.1 million and \$2.4 million as of December 31, 2006 and September 30, 2007, respectively.

We write down our inventory for estimated obsolescence or damage equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Once established, the original cost of the inventory less the related inventory reserve represents the new cost basis of such products. Reversal of these reserves is recognized only when the related inventory has been sold or scrapped. At December 31, 2006, our inventory balance was \$20.3 million, net of allowance for obsolescence or damaged inventory of \$6.6 million. At September 30, 2007, our inventory balance was \$22.4 million, net of allowance for obsolescence or damaged inventory of \$2.2 million.

*Internal-Use Software and Website Development.* Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our Website and processes supporting our business. As

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required by Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, we capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

We capitalized \$7.3 million and \$209,000 of costs associated with internal-use software and website development during the three months ended September 30, 2006 and 2007, respectively, which are partially offset by amortization of previously capitalized amounts of \$3.6 million and \$3.2 million for those respective periods. During the nine months ended September 30, 2006 and 2007, we capitalized \$19.3 million and \$1.7 million, respectively, which are partially offset by amortization of previously capitalized amounts of \$9.9 million and \$10.3 million for those respective periods.

*Accounting for income taxes.* Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. As of December 31, 2006 and September 30, 2007, we have recorded a full valuation allowance of \$74.4 million and \$83.3 million, respectively, against our net deferred tax asset balance due to uncertainties related to our deferred tax assets as a result of our history of operating losses. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to change the valuation allowance, which could materially impact our financial position and results of operations.

*Valuation of long-lived and intangible assets and goodwill.* Under SFAS 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but must be tested for impairment at least annually. Other long-lived assets must also be evaluated for impairment when management believes that an asset has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the asset that may not be reflected in an asset's current carrying value, thereby possibly requiring an impairment charge in the future. Goodwill totaled \$2.8 million as of December 31, 2006 and September 30, 2007.

In conjunction with the decision to sell OTravel, our travel subsidiary, we performed an evaluation of its goodwill, pursuant to SFAS 144, *Accounting for the Impairment Long-Lived Assets*, and SFAS 142, *Goodwill and Other Intangible Assets*, and determined that goodwill was subject to an impairment loss of approximately \$4.5 million during year ended December 31, 2006 and \$3.8 million during the nine months ended September 30, 2007 (see Financial Statements Note 4 - Sale of Discontinued Operations). These have been recorded as a component of the loss from discontinued operations.

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

*Expected Volatility:* The fair value of stock options were valued using a volatility factor based on our historical stock prices.

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

*Expected Dividend:* We have not paid any dividends and do not anticipate paying dividends in the foreseeable future.

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

*Estimated Pre-vesting Forfeitures:* When estimating forfeitures, we consider voluntary and involuntary termination behavior.

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

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of our common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the

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percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan were originally payable in cash. During interim and annual periods prior to the third quarter of 2007, we recorded compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates included assumed future growth rates in revenues, gross margins and other factors. If we were to use different assumptions, the estimated compensation charges could be significantly different.

An amendment to the Performance Share Plan to allow us to make payments in the form of common stock was approved by the shareholders on May 15, 2007. In the third quarter of 2007, we engaged an independent third party valuation group to determine the fair value of the awards on the amendment date. Based on the independent third party valuation, we made the determination on August 7, 2007 to make the payments in the form of common stock, rather than cash. Therefore, we reclassified from their current status as liability awards to equity awards in accordance with FAS 123(R).

We reclassified a liability of approximately \$1.5 million related to performance share awards granted prior to the determination to additional-paid-in-capital and recognized additional compensation of approximately \$350,000 of compensation expense under the plan in general and administrative expenses for the quarter ended September 30, 2007, based on changes in our estimates regarding the ultimate growth in economic value expected to occur. During the quarter ended September 30, 2006, compensation expense under the Plan was reduced by \$100,000. For the nine months ended September 30, 2006 and 2007, compensation expense under the plan totaled \$800,000 and \$1.0 million, respectively. As of September 30, 2007, we have recognized \$1.9 million in total compensation expense under the plan.

#### *Recent Accounting Pronouncements.*

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

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

We adopted the provisions of FIN 48, on January 1, 2007. As a result of a full valuation allowance, we do not have any unrecognized tax benefits and there is no effect on our financial condition or results of operations as a result of implementing FIN 48. We are subject to audit by the IRS and various states for the prior 3 years. We do not believe there will be any material changes in its unrecognized tax positions over the next 12 months. Our policy is that we recognize interest and penalties accrued on any unrecognized tax positions as a component of income tax expense. As of the date of adoption of FIN 48, we did not have any accrued interest or penalties associated with any unrecognized tax positions, nor was any interest expense recognized during the quarter ended September 30, 2007.

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

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

### **Results of Operations**

The following table sets forth our results of operations expressed as a percentage of total revenue for the three and nine months ended September 30, 2006 and 2007:

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	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
	(as a percentage of total revenue)			
<b>Revenue</b>				
Direct	36.1%	24.4%	41.5%	27.5%
Fulfillment partner	63.9	75.6	58.5	72.5
Total revenue	100.0	100.0	100.0	100.0
<b>Cost of goods sold</b>				
Direct	32.5	20.5	37.1	23.2
Fulfillment partner	53.9	62.0	49.3	59.8
Total cost of goods sold	86.4	82.5	86.4	83.0
Gross profit	13.6	17.5	13.6	17.0
<b>Operating expense:</b>				
Sales and marketing	11.0	5.5	8.4	6.0
Technology	10.3	9.0	9.0	9.5
General and administrative	7.1	6.0	6.9	6.6
Restructuring				2.6
Total operating expenses	28.4	20.5	24.3	24.7
Operating loss	(14.8)	(3.0)	(10.7)	(7.7)
Interest income, net	0.3	0.8	0.6	0.7
Interest expense	(0.7)	(0.6)	(0.7)	(0.7)
Other income, net	(0.0)	(0.1)	(0.0)	(0.0)
Loss from continuing operations	(15.2)%	(2.9)%	(10.8)%	(7.7)%

#### Comparison of Three and Nine Months Ended September 30, 2006 and 2007

##### Revenue

Total revenue increased 3%, from \$156.9 million during the three months ended September 30, 2006 to \$161.9 million during the same period in 2007. During that same period, direct revenue decreased 30%, from \$56.6 million in 2006 to \$39.4 million in 2007, while fulfillment partner revenue experienced 22% growth, from \$100.3 million in 2006 to \$122.5 million in 2007. For the nine-month period ended September 30, total revenue decreased 5% from \$494.1 million in 2006 to \$468.8 million in 2007. During that same nine-month period, direct revenue decreased 37%, from \$205.0 million in 2006 to \$128.7 million in 2007, while fulfillment partner revenue grew 18%, from \$289.1 million in 2006 to \$340.1 million in 2007.

##### Gross margin

Gross margins for the three months ended September 30, 2007 increased 390 basis points, from 13.6% in 2006 to 17.5% in 2007. Total cost of goods sold during the same three-month period decreased \$1.9 million or 1% from \$135.5 million in 2006 to \$133.7 million in 2007, resulting in a 32% increase in gross profits (from \$21.4 million in 2006 to \$28.3 million in 2007). As a percent of total revenue, cost of goods sold decreased from 86% to 83% for those respective periods, resulting in the improved gross margins. For the nine-month period ended September 30, 2007, gross margins increased 340 basis points, from 13.6% in 2006 to 17.0% in 2007. During that same nine-month period, total cost of goods sold decreased 9% from \$426.7 million in 2006 to \$388.9 million in 2007, resulting in improved gross profits from \$67.4 million in 2006 to \$79.9 million in 2007, an 18% increase. As a percent of total revenue, cost of goods sold decreased from 86% to 83% for the nine months ended September 30, 2006 and 2007, respectively.

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Cost of goods sold also includes stock-based compensation related to the adoption of SFAS 123(R) of \$103,000 and \$117,000 during the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, cost of goods sold included stock-based compensation of \$308,000 and \$338,000 respectively.

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

**Direct Gross Margins** Gross profits for our direct business grew 15% from \$5.5 million in 2006 to \$6.3 million for the three months ended September 30, 2007. Gross margins for our direct business increased from 9.7% to 16.0% for those respective periods. For the nine-month periods ended September 30, 2006 and 2007, gross profits for our direct business totaled \$21.8 million and \$19.9 million, respectively, a 9% decrease. Gross margins for our direct business increased from 10.6 % in 2006 to 15.5% in 2007. The lower gross profits are the result of direct revenue being down 37% from last year, primarily due to a significant reduction in direct inventory. However, gross margins have increased at the same time, since the remaining inventory in general turns faster and has higher profitability. Gross margins have also improved from the reduction of fulfillment costs (defined as warehousing costs, credit card fees and customer service costs see further discussion in the following section entitled Fulfillment Costs ) to 7% of sales, a 180 basis point improvement from 8.8% of sales in the first nine months of 2006.

**Fulfillment Partner Gross Margins** Our fulfillment partner business generated gross profits of \$15.8 million and \$22.0 million, for the three months ended September 30, 2006 and 2007, respectively, an increase of 39%. Gross margins for the fulfillment partner business also increased from 15.8% in 2006 to 18.0% in 2007 for those respective periods. For the nine month-periods ended September 30, 2006 and 2007, our fulfillment partner business generated gross profits of \$45.6 million and \$60.0 million, respectively, a 32% improvement. Gross margins for fulfillment partner business increased from 15.8% in 2006 to 17.6%

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in 2007 for those respective periods. This increase in gross profit dollars is the result of the 15% increase in fulfillment partner revenue combined with increased gross margins. The increase in partner gross margins is the result of better product pricing and improvements in partner fulfillment costs, particularly the cost of customer service.

### Fulfillment costs

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

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

(in thousands)	Three months ended September 30,				Nine months ended September 30,			
	2006		2007		2006		2007	
Total revenue	\$ 156,885	100%	\$ 161,930	100%	\$ 494,121	100%	\$ 468,827	100%
Cost of goods sold:								
Product costs, freight costs and other cost of good sold	123,187	78%	124,124	77%	384,469	78%	357,893	76%
Fulfillment costs	12,333	8%	9,545	6%	42,225	8%	31,055	7%
Total cost of goods sold	135,520	86%	133,669	83%	426,694	86%	388,948	83%
Gross profit	\$ 21,365	14%	\$ 28,261	17%	\$ 67,427	14%	\$ 79,879	17%

As displayed in the above table, fulfillment costs during the three months ended September 30, 2006 and 2007 were \$12.3 million and \$9.5 million, respectively, or 8% and 6% of total revenue for those respective periods. For the nine months ended September 30, 2006 and 2007, fulfillment costs totaled \$42.2 million and \$31.1 million, respectively, or 8% and 7% of total revenue for those respective periods. Fulfillment costs as a percentage of sales may vary due to several factors, such as our ability to manage costs at our warehouses, significant changes in the number of units received and fulfilled, the extent to which we utilize third party fulfillment services and warehouses, and our ability to effectively manage customer service costs and credit card fees.

The decrease in fulfillment costs in 2007 has been the result of improved efficiencies in both our warehousing costs (including the reduction of warehouse space), and in our customer service operations.

### Operating expenses

*Sales and marketing.* Sales and marketing expenses totaled \$17.3 million and \$8.8 million (49% decrease) for the three months ended September 30, 2006 and 2007, respectively, representing 11% and 5% of total revenue for those



respective periods. For the nine months ended September 30, 2006 and 2007, sales and marketing expenses totaled \$41.9 million and \$28.1 million (33% decrease), respectively, representing 8% and 6% of total revenue for those respective periods, down 250 basis points this year. We direct customers to our Website primarily through a number of targeted online marketing channels, such as sponsored search, affiliate marketing, portal advertising, e-mail campaigns, and other initiatives. We also utilize channels such as nation-wide television, print and radio advertising campaigns.

Costs associated with our discounted shipping promotions are not included in marketing expense (they are accounted for as a reduction of revenue and therefore affect sales growth and gross profit). We consider discounted shipping promotions as an effective marketing tool, and intend to continue to offer them as we deem appropriate as part of our overall marketing plan.

Sales and marketing expenses also include stock-based compensation related to the adoption of SFAS 123(R) in 2006 of \$77,000 and \$85,000 during the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, sales and marketing expenses included stock-based compensation of \$225,000 and \$248,000, respectively.

*Technology expenses.* Technology expenses decreased 10%, from \$16.2 million in 2006, to \$14.6 million for the same three-month period ended September 30, 2007, representing 10% and 9% of total revenue for those respective periods. For the nine months ended September 30, 2006 and 2007, technology expenses totaled \$44.5 million and \$44.8 million (1% increase), respectively, representing 9% of total revenue for those respective periods.

Technology expenses also included stock-based compensation related to the adoption of SFAS 123(R) in 2006 of \$173,000 and \$195,000 during the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, technology expenses included stock-based compensation of \$513,000 and \$560,000, respectively.

The year-over-year decrease in technology expenses in the third quarter relates to decreased depreciation expense. Although

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we continue to invest in new development and enhancements to our existing systems, we believe that our overall technology costs will continue to decrease in 2007 as depreciation decreases.

*General and administrative expenses.* General and administrative ( G&A ) expenses decreased 13%, from \$11.1million to \$9.7 million during the three months ended September 30, 2006 and 2007, respectively, representing approximately 7% and 6% of total revenue for each of the respective periods. For the nine months ended September 30, 2006 and 2007, G&A expenses totaled \$34.0 million and \$30.8 million (9% decrease), respectively, representing 7% of total revenue for both periods. The decrease in G&A expenses this quarter relates to decreases in corporate facilities costs, payroll-related expenses, professional fees, merchandising, legal and finance costs as we have made reductions to our corporate office space and headcount over the past nine months.

A large portion of our technology and general and administrative expenses are non-cash expenses. These non-cash expenses (which include depreciation and amortization and stock-based compensation) during the nine months ended September 30, 2007 were \$24.3 million, compared to similar non-cash expense of \$24.4 million for the nine months ended September 30, 2006. We estimate that that these non-cash expenses for the 2007 year will be approximately \$33-\$34 million.

Overall, our operating expenses were down 26% in the third quarter over the previous year, while revenue was up 3% and gross profits were up 32%.

We incurred stock-based compensation within general and administrative expenses of approximately \$689,000 and \$779,000 for the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, G&A expenses included stock-based compensation expense of \$2.0 million and \$2.2 million, respectively.

*Restructuring expenses.* During the fourth quarter of 2006, we commenced a facilities consolidation and restructuring program designed to reduce our overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program was substantially completed by the end of the second quarter of 2007. There were no restructuring expenses during the third quarter of 2007. (see Financial Statements Note 3 Restructuring Expenses ).

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

Although there were no restructuring charges in the third quarter, during the nine months ended September 30, 2007, we recorded \$8.0 million of restructuring charges related to the termination of a logistics services agreement, an agreement to terminate a lease related to our vacated warehouse facilities in Indiana and abandonment and marketing for sub-lease office and data center space in the current corporate office facilities. We also recorded an additional \$2.4 million of restructuring charges related to accelerated amortization of leasehold improvements located in the abandoned office and data center space and \$2.0 million of other restructuring charges, primarily related to consolidation of office

space in the current corporate office facilities, relocation of a data center and employee severance (see Financial Statements Note 3 Restructuring Expense ).

**Non-operating income (expense)**

*Interest income, interest expense and other income (expense).* Interest income derived from the investment of our cash in short-term investments was \$459,000 and \$1.3 million for the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, interest income totaled \$3.0 million and \$3.4 million, respectively. During Q2 of 2006, we recorded \$1.9 million of interest income related to the sale of Foreign Notes (see Financial Statements Note 5 Marketable Securities ). Excluding the gain on Foreign Notes during the first nine months of 2006, interest income is up \$2.3 million in the first nine months of 2007. This is due to both an increase in total cash and in interest rates in 2007 from 2006, and from interest income earned from our notes receivable related to the sale of our OTravel business in the second quarter of 2007 (see Financial Statements Note 4 Sale of Discontinued Operations ).

Interest expense is largely related to our convertible notes, capital leases and our credit lines. Interest expense decreased slightly from \$1.1 million during the three months ended September 30, 2006 to \$1.0 million during the same period in 2007. For the nine months ended September 30, 2006 and 2007, interest expense totaled \$3.6 million and \$3.1 million, respectively. The decrease in interest expense is due primarily to the fact that we had \$20 million of borrowings outstanding on our inventory line of credit in the first quarter of 2006, and no borrowings outstanding during the same period in 2007.

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

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### Sale of discontinued operations

As part of the program to reduce our expense structure and sell non-core businesses, we decided during the fourth quarter of 2006 to sell our travel subsidiary ( OTravel ). As a result, OTravel 's operations have been classified as a discontinued operation and therefore are not included in the results of continuing operations. The loss from discontinued operations for OTravel was \$708,000 and zero for the three months ended September 30, 2006 and 2007, respectively and \$2.6 million and \$3.9 million (including \$3.8 million related to impairment of goodwill recorded in the first quarter of 2007), for the nine months ended September 30, 2006 and 2007, respectively.

In conjunction with the discontinuance of OTravel, we performed an evaluation of the goodwill associated with the reporting unit pursuant to SFAS 142, and SFAS 144, *Accounting for the Impairment of Long-Lived Assets* and determined that goodwill of approximately \$4.5 million was impaired as of December 31, 2006 based on a non-binding letter of intent from a third party to purchase this business. On April 25, 2007, we completed the sale of OTravel for cash proceeds of \$9.9 million, net of cash transferred, and \$6.0 million of notes. Based on the estimated fair value of the discounted cash flows of the net proceeds from the sale, we recorded an additional goodwill impairment of \$3.8 million during the quarter ended March 31, 2007 (see Financial Statements Note 4 Sale of Discontinued Operations ).

### Income taxes

*Income taxes.* For the nine months ended September 30, 2006 and 2007, we incurred net operating losses, and consequently paid insignificant amounts of federal, state and foreign income taxes. As of December 31, 2006 and September 30, 2007, we had net operating loss carryforwards of approximately \$145.2 million and \$174.5 million, respectively, which may be used to offset future taxable income. An additional \$14.4 million of net operating losses are limited under Internal Revenue Code Section 382 to \$799,000 a year. These net operating loss carryforwards will begin to expire in 2018.

### Seasonality

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

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2007	\$ 157,930	\$ 148,967	\$ 161,930	
2006	178,044	159,192	156,885	\$ 294,029
2005	165,881	150,638	167,779	315,018
2004	82,078	87,792	103,444	221,321

### Off-Balance Sheet Arrangements

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

### **Liquidity and Capital Resources**

Prior to the second quarter of 2002, we financed our activities primarily through a series of private sales of equity securities, warrants to purchase our common stock and promissory notes. During the second quarter of 2002, we completed our initial public offering pursuant to which we received approximately \$26.1 million in cash, net of underwriting discounts, commissions, and other related expenses. Additionally, we completed follow-on offerings in February 2003, May 2004 and November 2004, pursuant to which we received approximately \$24.0 million, \$37.9 million and \$75.2 million, respectively, in cash, net of underwriting discounts, commissions, and other related expenses. In November 2004, we also received \$116.2 million in proceeds from the issuance of our convertible senior notes in a transaction event exempt from registration under the Securities Act. During 2006, we received \$64.4 million from two private stock offerings in May and December. At September 30, 2007, our cash and cash equivalents balance was \$74.1 million and we had \$16.8 in marketable securities, for a total of \$91.0 million of cash, cash equivalents and marketable securities.

Our operating activities resulted in net cash inflows of \$764,000 and net cash outflows of \$2.5 million for the three months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, operating activities resulted in net cash outflows of \$78.2 million and \$45.8 million, respectively. We have payment terms with our fulfillment partners that extend beyond the amount of time necessary to collect proceeds from our customers. As a result, following our seasonally strong fourth quarter sales, at December 31 of each year, our cash, cash equivalents, marketable securities and accounts payable balances typically reach their highest level (other than as a result of cash flows provided by or used in investing and financing activities). However, our accounts payable balance normally declines during the first nine months following year-end, which normally results in a decline in our cash, cash equivalents, and marketable securities balances from the year-end balance over the first nine months of each year.

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Due to the strong effect of seasonality on our cash and marketable securities balance, we believe that the best measure of our cash flow is on a TTM basis. The seasonality of our business causes payables and accruals to grow significantly in the fourth quarter, and then decrease in the first quarter when they are paid. Over the trailing twelve months ended September 30, our operating activities resulted in net cash outflows of \$20.5 million in 2006 and net cash inflows of \$6.2 million in 2007, respectively. This \$26.7 million improvement is largely the result of a \$46.4 million decrease in our inventory balance (from \$68.8 million down to \$22.4 million) over the past twelve months.

The primary use of cash and cash equivalents during the three months ended September 30, 2006 was to fund our operations, including net losses of \$24.5 million, as well as the change in accrued liabilities of \$3.3 million. This was offset by the cash provided from changes in receivables, inventory, and accounts payable of \$1.5 million, \$6.0 million, and \$11.7 million, respectively.

For the three months ended September 30, 2007, the primary use of cash and cash equivalents during the three months ended September 30, 2007 was to fund our operations, including net losses of \$4.7 million, as well as changes in inventory, prepaid inventory, prepaid expenses, and accrued liabilities of \$7.0 million, \$2.9 million, \$1.5 million, and \$566,000, respectively. This was offset by cash provided from the change in accounts payable of \$5.0 million.

Net cash used in operating activities for the nine months ended September 30, 2006 totaled \$78.3 million which included the funding of our net losses of \$56.2 million (which includes loss from discontinued operations of \$2.6 million, depreciation and amortization of \$20.8 million and stock-based compensation of \$3.8 million), as well as changes in accounts payable and accrued liabilities of \$53.5 million and \$26.9 million, respectively. Net cash used in operating activities was partially offset by cash provided from the changes in accounts receivable, inventories and prepaid inventory of \$2.9 million, \$24.5 million and \$5.6 million, respectively.

For the nine months ended September 30, 2007, the net cash used in operating activities of \$45.8 million was mainly due to our net losses of \$39.9 million (which includes loss from discontinued operations of \$3.9 million, depreciation and amortization of \$22.8 million, stock-based compensation of \$4.9 million and restructuring charges of \$12.3 million,) and changes in inventory, prepaid inventory, prepaid expenses, accounts payables and accrued liabilities of \$2.1 million, \$2.8 million, \$2.8 million, \$27.6 million and \$19.0 million, respectively. The operating outflows for the same period were offset mainly by operating cash inflows from the change in accounts receivable of \$3.7 million. Due to seasonality, our operating cash flows show a \$45.8 million outflow over the first nine months of the year (note that combined payables and accruals have decreased by \$46.3 million). Our operating cash flows were a positive \$6.2 million for the TTM ending September 30, 2007, versus an outflow of \$20.5 million over the same period a year ago.

Investing activities resulted in net cash outflows of \$7.8 million and net cash inflows of \$1.3 million for the three months ended September 30, 2006 and 2007, respectively. The cash outflows from investing activities in 2006 were the result of expenditures for property and equipment. Investing activities in 2007 resulted from net cash received from the purchases and sales of marketable securities of \$1.1 million, and \$502,000 of payments received from a note receivable, offset by capital expenditures of \$316,000. For the nine months ended September 30, 2006 and 2007, investing activities resulted in cash inflows of \$37.2 million and net cash outflows of \$4.0 million, respectively. Investing activities in 2006 consisted of \$56.8 million received from the sale of marketable securities offset by capital expenditures of \$19.6 million. The \$4.0 million used in investing activities during the same nine-month period in 2007 resulted from the net cash outflows from purchases and sales of marketable securities of \$16.8 million and expenditures of property and equipment of \$2.2 million, offset by payments received from a note receivable of \$5.2 million and the net proceeds from the sale of OTravel of \$9.9 million.

Financing activities resulted in cash inflows of \$682,000 and \$256,000 during the three months ended September 30, 2006 and 2007, respectively, largely from the proceeds received from the exercise of stock options. For the nine months ended September 30, 2006 and 2007, financing activities resulted in net cash inflows of \$24.4 million and net cash outflows of \$3.1 million, respectively. The cash provided in 2006 was primarily from the issuance of common stock for \$25.0 million and \$2.3 million received from the exercise of stock options. These

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financing activities were offset by payments for capital leases of \$2.9 million. The net cash used in financing activities in 2007 was primarily due to payments for capital leases of \$5.3 million offset by \$2.2 million received from the exercise of stock options.

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

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

*Contractual Obligations and Commitments.* The following table summarizes our contractual obligations as of September 30,

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2007 and the effect such obligations and commitments are expected to have on our liquidity and cash flow in future periods:

Contractual Obligations	Total	Payments Due by Period			
		Less than 1 Year	1-3 Years (in thousands)	4-5 Years	After 5 years
Long-term debt arrangements	\$ 77,000	\$	\$	\$ 77,000	\$
Interest on convertible senior notes	13,234	3,850	5,775	3,609	
Capital lease obligations	3,801	3,801			
Operating leases	44,604	8,422	12,345	11,576	12,261
Purchase obligations	31,683	31,683			
Line of credit					
Total contractual cash obligations	\$ 170,322	\$ 47,756	\$ 18,120	\$ 92,185	\$ 12,261

Other Commercial Commitments	Amounts of Commitment Expiration Per Period				
	Total Amounts Committed	Less than Year 1	1-3 Years (in thousands)	4-5 Years	Over 5 years
Letters of credit	\$ 2,705	\$ 2,705	\$	\$	\$
Total commercial commitments	\$ 2,705	\$ 2,705	\$	\$	\$

### 3.75% Convertible Senior Notes

In November 2004, we completed an offering of \$120.0 million of 3.75% Convertible Senior Notes (the Senior Notes). Interest on the Senior Notes is payable semi-annually on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2011 and are unsecured and rank equally in right of payment with all existing and future unsecured, unsubordinated debt and senior in right of payment to any existing and future subordinated indebtedness. The Senior Notes are convertible at any time prior to maturity into our common stock at the option of the note holders at a conversion price of \$76.23 per share (subject to adjustment in certain events, including stock splits, dividends and other distributions and certain repurchases of our stock, as well as certain fundamental changes in our ownership).

Beginning December 1, 2009, we have the right to redeem the Senior Notes, in whole or in part, for cash at 100% of the principal amount plus accrued and unpaid interest. Upon the occurrence of a fundamental change (including the acquisition of a majority interest in us, certain changes in our board of directors or the termination of trading of our stock) meeting certain conditions, holders of the Senior Notes may require us to repurchase for cash all or part of their notes at 100% of the principal amount plus accrued and unpaid interest.

The indenture governing the Senior Notes requires us to comply with certain affirmative covenants, including making principal and interest payments when due, maintaining our corporate existence and properties, and paying taxes and other claims in a timely manner. We were in compliance with these covenants at September 30, 2007.

In 2005, under the Share Repurchase Program discussed below, we retired \$43.0 million of the Senior Notes for \$35.7 million in cash. As a result of the note retirements, we recognized a gain of \$6.2 million, net of the associated unamortized discount of \$1.2 million for the year ended December 31, 2005. As of September 30, 2007, \$77.0 million of Senior Notes and unamortized debt discount of \$1.5 million remain outstanding.



*Lease and Purchase Obligations*

The lease obligations include our obligations under a ten-year lease agreement we entered in December 2004 for approximately 154,000 square feet of office space in Salt Lake City. We took possession of the new office space in July of 2005 and terminated our lease obligations under our previous office lease agreements at the same time. The total lease obligation over the ten-year term of the new lease is \$39.6 million, of which approximately \$4.2 million is payable in the next twelve months.

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

During the fourth quarter 2006, we commenced implementation of a facilities consolidation and restructuring program. We recorded a liability of \$450,000 for the costs to dismantle and dispose of an escalator system and to return the leased facilities to their original condition under the Tenant Improvement Agreement and incurred additional amortization expense in connection with the revised useful life of certain leasehold improvements. In the second quarter of 2007, we abandoned and began marketing for sub-lease office and data center space in the current corporate office facilities and recorded an additional \$2.4 million of

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restructuring charges related to accelerated amortization of leasehold improvements located in the abandoned office and data center space and \$2.0 million of other restructuring charges, primarily related to consolidation of office space in the current corporate office facilities, relocation of a data center and employee severance (see Financial Statements Note 3 Restructuring Expense ).

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

In July 2004, we entered into a logistics service agreement (the Logistics Agreement ) wherein the handling, storage and distribution of our prepackaged products is performed by a third party within 425,000 square feet in Indiana. The Logistics Agreement and subsequent amendment set forth terms on which we paid various fixed fees based on square feet of storage and various variable costs based on product handling costs for a term of five years. In February 2007, we gave a nine-month notice of termination of this agreement. We estimate the termination costs of this agreement at approximately \$1.4 million payable in August 2007, which costs include prepayment of 6 months of fees under the agreement and payment of costs associated with improvement and equipment removal (see Financial Statements Note 3 Restructuring Expense ).

In December 2005, we entered into a warehouse facilities lease agreement (the License Agreement ) to license approximately 400,000 square feet of warehouse space in Indiana. The License Agreement was subsequently amended, reducing the amount of lease space to approximately 300,000 and extending the term to 2011. In February 2007 we made the determination to close our Indiana warehouse operations. As a result, our Indiana landlord has agreed to allow a sublease or assumption of the lease on the remaining 300,000 square feet. We estimated the net cost over the remaining life of this lease (net of any amounts we may receive from sublease) to be \$3.2 million at the end of Q1 2007 and recorded a liability under the restructuring program during this quarter. During the second quarter of 2007, we reached an agreement to terminate the Indiana warehouse facilities lease effective August 15, 2007 for \$1.9 million, resulting in a reversal of restructuring expense of approximately \$1.0 million (see Financial Statements Note 3 Restructuring Expense ).

In December 2006, we entered into a Co-location Center Agreement (the OM I Co-location Agreement ) to lease 3,999 square feet of space at Old Mill Corporate Center I for an IT co-location data center to allow us to consolidate other IT data center facilities at the Old Mill Corporate Center II and at our current corporate offices facilities.

The Company leases 561,000 square feet for its warehouse facilities in Utah under operating leases which expire in August 2012. The Company has also temporarily leased an additional 251,000 square feet of warehouse space in Utah under operating leases for the seasonal increase in inventory during the fourth quarter of 2007.

The amount of purchase obligations shown is based on assumptions regarding the legal enforceability against us of purchase orders we had outstanding at September 30, 2007. Under different assumptions regarding our rights to cancel our purchase orders or different assumptions regarding the enforceability of the purchase orders under applicable law, the amount of purchase obligations shown in the table above would be less.

#### *Borrowings*

*\$30.0 million Amended Credit Agreement*

On October 18, 2005, we entered into a sixth amendment to a credit agreement (as amended to date, the *Amended Credit Agreement* ) with Wells Fargo Bank, N.A. The Amended Credit Agreement provides a revolving line of credit to us of up to \$30.0 million which we use primarily to obtain letters of credit to support inventory purchases. Borrowings and outstanding letters of credit under the credit agreement are collateralized by cash balances held at Wells Fargo Bank, N.A. The Amended Credit Agreement expires on December 31, 2007; however, we have an option to renew the Amended Credit Agreement annually. Interest on borrowings is payable monthly and accrued at either (i) 1.35% above LIBOR in effect on the first day of an applicable fixed rate term, or (ii) at a fluctuating rate per annum determined by the bank to be one half a percent (0.50%) above daily LIBOR in effect on each business day a change in daily LIBOR is announced by the bank. Unpaid principal, together with accrued and unpaid interest, is due on the maturity date.

The Amended Credit Agreement requires us to comply with certain covenants, including restrictions on mergers, business combinations or transfer of assets. We were in compliance with these covenants at September 30, 2007.

The facility does not provide liquidity to us, as borrowings are required to be completely cash-collateralized.

At September 30, 2007, no amounts were outstanding under the Amended Credit Agreement, and letters of credit totaling \$2.7 million were issued on our behalf.

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*\$40.0 million WFRF Agreement*

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

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

Advances under the WFRF Agreement bear interest at either (a) the rate announced, from time to time, within Wells Fargo Bank, N.A. at its principal office in San Francisco as its prime rate or (b) a rate based on LIBOR plus a varying percentage between 1.25% and 1.75%; however, the annual interest rate on advances under the WFRF Agreement will be at least 3.50%. The WFRF Agreement includes affirmative covenants as well as negative covenants that prohibit a variety of actions without the lender's approval, including covenants that limit our ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another person, (d) sell assets, (e) change our name or the name of any of our subsidiaries, (f) make certain changes to our business, (g) optionally prepay, acquire or refinance indebtedness, (h) consign inventory, (i) pay dividends on, or purchase, acquire or redeem shares of, our capital stock, (j) change our method of accounting, (k) make investments, (l) enter into transactions with affiliates, or (m) store any of our inventory or equipment with third parties. We were in compliance with these covenants as of September 30, 2007. At September 30, 2007, no amounts were outstanding under the WFRF Agreement. As of September 30, 2007, availability under the WFRF Agreement was \$8.8 million.

*Share Repurchase Program*

During January 2005, our Board of Directors authorized a share repurchase program under which we were authorized to repurchase up to \$50.0 million of our common stock through December 31, 2007. On April 26, 2005, the Board of Directors increased the amount of the share repurchase program to \$100.0 million. Additionally, on June 14, 2005, the Board of Directors authorized an amendment of our three-year share repurchase program to include the repurchase of our Convertible Senior Notes. Under the repurchase program, we repurchased approximately 665,000 shares of our common stock in open market transactions for \$24.1 million during the year ended December 31, 2005. In addition, approximately 1.0 million shares of common stock were acquired as a result of the settlement of \$41.1 million of structured stock repurchase transactions during the year ended December 31, 2005. The purchased call options that did not settle in stock settled in cash totaling \$7.9 million, which we received in July 2005. We also repurchased convertible senior notes having an aggregate principal amount of \$43.0 million during 2005. As of December 31, 2005, we have utilized all of the \$100.0 million authorized by the board of directors under the share repurchase program.

*Shelf Registration*

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In April 2005, we filed a registration statement with the Securities and Exchange Commission using a shelf registration or continuous offering process. Under this shelf process, we may, from time to time, sell any or all of the securities described in the prospectus in one or more offerings up to a total dollar amount of \$500.0 million. On May 1, 2006, we issued approximately 1,042,000 shares of common stock for net proceeds of approximately \$25.0 million. Additionally, on December 12, 2006, we issued approximately 2,734,000 shares for net proceeds of approximately \$39.4 million. There have been no issuances of common stock in 2007.

### **Government Regulation**

All of our services are subject to federal and state consumer protection laws including laws protecting the privacy of consumer non-public information and regulations prohibiting unfair and deceptive trade practices. In particular, under federal and state financial privacy laws and regulations, we must provide notice to consumers of our policies on sharing non-public information with third parties, must provide advance notice of any changes to our policies and, with limited exceptions, must give consumers the right to prevent sharing of their non-public personal information with unaffiliated third parties. Furthermore, the growth and demand for online commerce could result in more stringent consumer protection laws that impose additional compliance burdens on online companies. These consumer protection laws could result in substantial compliance costs and could interfere with the conduct of our business.

In many states, there is currently great uncertainty whether or how existing laws governing issues such as property ownership, sales and other taxes, libel and personal privacy apply to the Internet and commercial online services. These issues may take years to resolve. In addition, new state tax regulations may subject us to additional state sales and income taxes. New legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business or the application of existing laws and regulations to the Internet and commercial online services could result in significant additional taxes on our business. These taxes could have an adverse effect on our cash flows and results of operations.

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Furthermore, there is a possibility that we may be subject to significant fines or other payments for any past failures to comply with these requirements.

### **Factors that May Affect Future Results**

Any investment in our securities involves a high degree of risk. Investors should consider carefully the risks and uncertainties described in this Form 10-Q, and all other information in this Form 10-Q and in our other filings with the SEC including those we file after we file this Form 10-Q, before deciding whether to purchase or hold our securities. Additional risks and uncertainties not currently known to us or that we currently deem immaterial may also become important factors that may harm our business. The occurrence of any of the risks described in Item 1A of Part II of this Form 10-Q could harm our business. The trading price of our securities could decline due to any of these risks and uncertainties, and investors may lose part or all of their investment.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash and cash equivalents, marketable securities, trade accounts and contracts receivable, accounts payable and long-term obligations. We consider investments in highly-liquid instruments purchased with a remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Our exposure to market risk for changes in interest rates relates primarily to our short-term investments and short-term obligations; thus, fluctuations in interest rates would not have a material impact on the fair value of these securities.

At September 30, 2007, we had \$74.1 million in cash and cash equivalents and \$16.8 million in marketable securities. Hypothetically, an increase or decrease in interest rates of one hundred basis points would have an estimated impact of \$910,000 on our earnings or loss, or the fair market value or cash flows of these instruments.

At September 30, 2007, we had approximately \$77.0 million of convertible senior notes outstanding which bear interest at a fixed rate of 3.75%. In addition, at September 30, 2007, there were no borrowings outstanding under our lines of credit and letters of credit totaling \$2.7 million were outstanding under our credit facilities.

The fair value of the convertible senior notes is sensitive to interest rate changes. Interest rate changes would result in increases or decreases in the fair value of the convertible senior notes, due to differences between market interest rates and rates in effect at the inception of the obligation. Unless we elect to repurchase our convertible senior notes in the open market, changes in the fair value of convertible senior notes have no impact on our cash flows or consolidated financial statements. The estimated fair value of our 3.75% Convertible Senior Notes of September 30, 2007 was \$64.1 million.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to ensure that information relating to the Company and its consolidated subsidiaries required to be disclosed in the Company's periodic filings under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported in a timely manner in accordance with the requirements of the Exchange Act, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer), as appropriate, to allow timely decisions regarding required disclosure. The Company carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer), of the effectiveness of the design and operation of these disclosure controls and procedures, as such term is defined in Exchange Act Rule 13a-15(e), as of September 30, 2007. Based on this evaluation, the Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer) each concluded that the Company's disclosure controls and procedures were effective as of September 30, 2007.

#### **Changes in Internal Control Over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **PART II. OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

The information set forth under Note 12 Commitments and Contingencies, subheading Legal Proceedings, contained in the Notes to Unaudited Consolidated Financial Statements of this Quarterly Report on Form 10-Q is incorporated by reference in answer to this Item.

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## ITEM 1A. RISK FACTORS

*Please consider the following risk factors carefully. If any one of the following risks were to occur, our business, financial condition, operating results and cash flows could be materially adversely affected. In addition, these are not the only risks we face.*

### **Risks Relating to Overstock**

**We have a history of significant losses. If we do not achieve profitability, our financial condition and our stock price could suffer.**

We have a history of losses and we may continue to incur operating and net losses for the foreseeable future. We incurred net losses of \$4.7 million and \$39.9 million for the three and nine months ended September 30, 2007. As of September 30, 2007, our accumulated deficit was \$238.5 million. We will need to generate significant revenues to achieve profitability, and we may not be able to do so. Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis in the future. If our revenues grow more slowly than we anticipate, or if our operating expenses exceed our expectations, our financial results would be harmed.

We will continue to incur significant operating expenses and some capital expenditures to

enhance our distribution and order fulfillment capabilities;

further improve our order processing systems and capabilities;

develop enhanced technologies and features;

expand our customer service capabilities to better serve our customers' needs;

expand or modify our product offerings;

rent or terminate warehouse and office space;



increase our general and administrative functions to support our operations; and

maintain or increase our sales, branding and marketing activities, including maintaining existing or entering into new online marketing arrangements, and continuing or increasing our national television and radio branding campaigns.

Because we will incur many of these expenses before we receive any revenues from our efforts, our losses may be greater than the losses we would incur if we developed our business more slowly. Further, we base our expenses in large part on our operating plans and future revenue projections. Many of our expenses are fixed in the short term, and we may not be able to quickly reduce spending if our revenues are lower than we project. Therefore, any significant shortfall in revenues would likely harm our business, prospects, operating results and financial condition. In addition, we may find that these efforts are more expensive than we currently anticipate which would further increase our losses. Also, the timing of these expenses may contribute to fluctuations in our quarterly operating results.

**If we fail to accurately forecast our expenses and revenues, our business, operating results and financial condition may suffer and the price of our securities may decline.**

Our limited operating history and the rapidly evolving nature of our industry make forecasting operating results difficult. We have recently completed several large, complex and expensive infrastructure upgrades in order to increase our ability to handle larger volumes of sales and to develop or increase our ability to perform a variety of analytical procedures relating to our business, and we are continuing the work to upgrade and further expand these and other components of our infrastructure. We have experienced difficulties with the implementation of various aspects to the upgrades of our infrastructure, and have incurred increased expenses as a result of these difficulties. As a result of these expenditures, our ability to quickly reduce spending if our revenues are lower than we project is limited. Therefore, any significant shortfall in the revenues for which we have built and are continuing to build our infrastructure would likely harm our business, prospects, operating results and financial condition and cause our results of operation to fall below the expectations of public market analysts and investors. If this occurs, the price of our securities may decline.

**We depend on our relationships with third party fulfillment partners for a large portion of the products that we offer for sale on our Website. If we fail to maintain these relationships, our business will suffer.**

At September 30, 2007, we had fulfillment partner relationships with approximately 580 third parties whose products we offer for sale on our Website. These products accounted for approximately 72% of the non-BMMG products available. We do not have any long-term agreements with any of these third parties. Our agreements with third parties are terminable at will by either party immediately upon notice. In general, we agree to offer the third parties' products on our Website and these third parties agree

to provide us with information about their products, honor our customer service policies and ship the products directly to the customer. If we do not maintain our existing relationships or build new relationships with third parties on acceptable commercial terms, we may not be able to offer a broad selection of merchandise, and customers may refuse to shop at our Website. In addition, manufacturers may decide not to offer particular products for sale on the Internet. If we are unable to maintain our existing or build new fulfillment partner relationships or if other product manufacturers refuse to allow their products to be sold via the Internet, our business and prospects would suffer severely.

**We are partially dependent on third parties to fulfill a number of our fulfillment, distribution and other retail functions. If such parties are unwilling or unable to continue providing these services, our business could be seriously harmed.**

In our fulfillment partner business, although we handle returned merchandise, we continue to rely on third parties to conduct a number of other traditional retail operations with respect to their respective products that we offer for sale on our Website, including maintaining inventory, preparing merchandise for shipment to individual customers and timely distribution of purchased merchandise. We have no effective means to ensure that these third parties will continue to perform these services to our satisfaction or on commercially reasonable terms. In addition, because we do not take possession of these third parties' products, we are unable to fulfill these traditional retail operations ourselves. Our customers could become dissatisfied and cancel their orders or decline to make future purchases if these third parties are unable to deliver products on a timely basis. If our customers become dissatisfied with the services provided by these third parties, our reputation and the Overstock.com brand could suffer.

**We rely on our relationships with manufacturers, retailers and other suppliers to obtain sufficient quantities of quality merchandise on acceptable terms. If we fail to maintain our supplier relationships on acceptable terms, our sales and profitability could suffer.**

To date, we have not entered into contracts with manufacturers or liquidation wholesalers that guarantee the availability of merchandise for a set duration. Our contracts or arrangements with suppliers do not provide for the continuation of particular pricing practices and may be terminated by either party at any time. Our current suppliers may not continue to sell their excess inventory to us on current terms or at all and we may not be able to establish new supply relationships. For example, it is difficult for us to maintain high levels of product quality and selection because none of the manufacturers, suppliers and liquidation wholesalers from whom we purchase products on a purchase order by purchase order basis have a continuing obligation to provide us with merchandise at historical levels or at all. In most cases, our relationships with our suppliers do not restrict the suppliers from selling their respective excess inventory to other traditional or online merchandise liquidators, which could in turn limit the selection of products available on our Website. If we are unable to develop and maintain relationships with suppliers that will allow us to obtain sufficient quantities of merchandise on acceptable commercial terms, such inability could harm our business, prospects, results of operation and financial condition.

**We depend upon third-party delivery services to deliver our products to our customers on a timely and consistent basis. Deterioration in our relationship with any one of these third parties could decrease our ability to track shipments, cause shipment delays, and increase our shipping costs and the number of damaged products.**

We rely upon multiple third parties for the shipment of our products. We cannot be sure that these relationships will continue on terms favorable to us, if at all. Unexpected increases in shipping costs or delivery times, particularly during the holiday season, could harm our business, prospects, financial condition and results of operations. If our relationships with these third parties are terminated or impaired or if these third parties are unable to deliver products for us, whether through labor shortage, slow down or stoppage, deteriorating financial or business condition, responses to terrorist attacks or for any other reason, we would be required to use alternative carriers for the shipment of products to our customers. In addition, conditions such as adverse weather can prevent any carriers from performing their delivery services, which can have an adverse effect on our customers' satisfaction with us. In any of these circumstances, we may be unable to engage alternative carriers on a timely basis, upon terms favorable to us, or at all. Changing carriers would likely have a negative effect on our business, prospects, operating

results and financial condition. 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 gross margins; and

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

**A significant number of merchandise returns could harm our business, financial condition and results of operations.**

We allow our customers to return products and we accept returns of products. We modify our policies relating to returns from time to time and any policies intended to reduce the number of product returns may result in customer dissatisfaction and fewer repeat customers. If merchandise returns are significant, our business, prospects, financial condition and results of operations could be harmed.

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**If the products that we offer on our Website do not reflect our customers' tastes and preferences, our sales and profit margins would decrease.**

Our success depends in part on our ability to offer products that reflect consumers' tastes and preferences. Consumers' tastes are subject to frequent, significant and sometimes unpredictable changes. Because some of the products that we sell consist of manufacturers' and retailers' excess inventory, we have limited control over some of the specific products that we are able to offer for sale. If our merchandise fails to satisfy customers' tastes or respond to changes in customer preferences, our sales could suffer and we could be required to mark down unsold inventory which would depress our profit margins. In addition, any failure to offer products in line with customers' preferences could allow our competitors to gain market share. This could have an adverse effect on our business, prospects, results of operations and financial condition.

**We face risks relating to our inventory.**

We directly purchase some of the merchandise that we sell on our Website. We assume the inventory damage, theft and obsolescence risks, as well as price erosion risks for products that we purchase directly. These risks are especially significant because some of the merchandise we sell on our Website is characterized by rapid technological change, obsolescence and price erosion (for example, computer hardware, software and consumer electronics) and because we sometimes make large purchases of particular types of inventory. In addition, we often do not receive warranties on the merchandise we purchase. We accept returns of products sold through our fulfillment partners and we have the risk of reselling the returned products.

In the recent past we have recorded charges for obsolete inventory and have had to sell certain merchandise at a discount or loss. It is impossible to determine with certainty whether an item will sell for more than the price we pay for it. To the extent that we rely on purchased inventory, our success will depend on our ability to liquidate our inventory rapidly, the ability of our buying staff to purchase inventory at attractive prices relative to its resale value and our ability to manage customer returns and the shrinkage resulting from theft, loss and misrecording of inventory. If we are unsuccessful in any of these areas, we may be forced to sell our inventory at a discount or loss.

**The loss of key personnel or any inability to attract and retain additional personnel could affect our ability to successfully grow our business.**

Our performance is substantially dependent on the continued services and on the performance of our senior management and other key personnel, including Patrick M. Byrne, our Chief Executive Officer, and Jason C. Lindsey, our President and Chief Operating Officer. Our performance also depends on our ability to retain and motivate other officers and key employees. The loss of the services of any of our executive officers or other key employees for any unforeseen reason, including without limitation, illness or call to military service, could harm our business, prospects, financial condition and results of operations. We do not have employment agreements with any of our key personnel and we do not maintain key person life insurance policies. Our future success also depends on our ability to identify, attract, hire, train, retain and motivate other highly-skilled technical, managerial, editorial, merchandising, marketing and customer service personnel. Competition for such personnel is intense, and we cannot assure you that we will be able to successfully attract, assimilate or retain sufficiently qualified personnel. Our failure to retain and attract the necessary technical, managerial, editorial, merchandising, marketing and customer service personnel could harm our revenues, business, prospects, financial condition and results of operations.

**We have a rapidly evolving business model.**

Our business model has evolved and continues to do so. In the past we have added additional types of services and product offerings and in some cases, we have modified or discontinued those offerings. We may continue to try to offer additional types of products or services and we cannot offer any assurance that any of them will be successful. From time to time we have also modified aspects of our business model relating to our product mix and the mix of direct/fulfillment partner sourcing of the products we offer. We may continue to modify this aspect of our business as well as other significant aspects of our business. We cannot offer any assurance that these or any other modifications will be successful.

**We may be unable to manage expansion into new business areas which could harm our business operations and reputation.**

Our long-term strategic plan involves expansion of our operations to offer additional types of products and services. We cannot assure you that our efforts to expand our business in this manner will succeed. We have attempted to expand into other areas. Our failure to succeed in these markets or businesses or in other product or service offerings may harm our business, prospects, financial condition and results of operation. We cannot assure you that we will be able to expand our operations in a cost-effective or timely manner or that our efforts to expand will be successful. Furthermore, any new business or website we launch that is not favorably received by consumers could damage our reputation or the Overstock.com brand. We may expand the number of categories of products we carry on our Website and these and any other expansions of our operations would also require significant additional expenses and development and would strain our management, financial and operational resources. The lack of market acceptance of such efforts or our inability to generate satisfactory revenues from such expanded services or products to offset their cost could harm our business, prospects, financial condition and results of operations.

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**We may expand our international business, causing our business to become increasingly susceptible to numerous international business risks and challenges that could affect our profitability.**

We have begun to expand into international markets, and in the future we may do so more aggressively. International sales and transactions are subject to inherent risks and challenges that could adversely affect our profitability, including:

the need to develop new supplier and manufacturer relationships;

the need to comply with additional laws and regulations to the extent applicable;

unexpected changes in international regulatory requirements and tariffs;

difficulties in staffing and managing foreign operations;

longer payment cycles from credit card companies;

greater difficulty in accounts receivable collection;

potential adverse tax consequences;

price controls or other restrictions on foreign currency; and

difficulties in obtaining export and import licenses.

To the extent we generate international sales and transactions in the future, any negative impact on our international operations could negatively impact our business. In particular, gains and losses on the conversion of foreign payments into United States dollars may contribute to fluctuations in our results of operations and fluctuating exchange rates could cause reduced gross revenues and/or gross margins from non-dollar-denominated international sales.

**In order to obtain future revenue growth and achieve and sustain profitability, we will have to attract and retain customers on cost-effective terms.**

Our success depends on our ability to attract and retain customers on cost-effective terms. We have relationships with online services, search engines, directories and other websites and e-commerce businesses to provide content, advertising banners and other links that direct customers to our Website. We rely on these relationships as significant sources of traffic to our Website and to generate new customers. If we are unable to develop or maintain these relationships on acceptable terms, our ability to attract new customers and our financial condition could be harmed. In addition, certain of our online marketing agreements may require us to pay upfront fees and make other payments prior to the realization of the sales, if any, associated with those payments. Accordingly, if these agreements or similar agreements that we may enter into in the future fail to produce the sales that we anticipate, our results of operations will be adversely affected. We cannot assure you that we will be able to increase our revenues, if at all, in a cost-effective manner. We periodically conduct national television and radio branding and advertising campaigns. Such campaigns are expensive and may not result in the cost effective acquisition of customers.

Further, many of the parties with which we may have online-advertising arrangements could provide advertising services for other online or traditional retailers and merchandise liquidators. As a result, these parties may be reluctant to enter into or maintain relationships with us. Failure to achieve sufficient traffic or generate sufficient revenue from purchases originating from third parties may result in termination of these relationships by these third parties. Without these relationships, our revenues, business, prospects, financial condition and results of operations could suffer.

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

The online liquidation services market is rapidly evolving and intensely competitive. Barriers to entry are minimal, and current and new competitors can launch new websites at a relatively low cost. Our consumer Website currently competes with:

liquidation e-tailers such as SmartBargains;

online retailers with discount departments such as Amazon.com, Inc., eBay, Inc. and Buy.com, Inc.; and

traditional retailers and liquidators such as Ross Stores, Inc., Walmart Stores, Inc., TJX Companies, Inc., Costco Wholesale Corporation, Target Corporation and Best Buy Co., Inc., which may or may not also have an online presence.

**Our Website competes with liquidation brokers and retailers and online marketplaces such as eBay, Inc.**

We expect the online liquidation services market to become even more competitive as traditional liquidators and online retailers continue to develop services that compete with our services. In addition, manufacturers and retailers may decide to create their own websites to sell their own excess inventory and the excess inventory of third parties. Competitive pressures created by any one of our competitors, or by our competitors collectively, could harm our business, prospects, financial condition and results of operations.

Further, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing,

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service or marketing decisions or acquisitions that could harm our business, prospects, financial condition and results of operations. For example, to the extent that we enter new lines of businesses such as third-party logistics, or discount brick and mortar retail, we would be competing with large established businesses such as APL Logistics, and Ltd., Ross Stores, Inc., respectively. We have recently entered the online auctions and car listing businesses in which we compete with large established businesses including eBay, Inc. and AutoTrader.com, Inc.

Many of our current and potential competitors described above have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. In addition, online retailers and liquidation e-tailers may be acquired by, receive investments from or enter into other commercial relationships with larger, well-established and well-financed companies. Some of our competitors may be able to secure merchandise from manufacturers on more favorable terms, devote greater resources to marketing and promotional campaigns, adopt more aggressive pricing or inventory availability policies and devote substantially more resources to Website and systems development than we do. Increased competition may result in reduced operating margins, loss of market share and a diminished brand franchise. We cannot assure you that we will be able to compete successfully against current and future competitors.

**Our operating results depend on our Website, network infrastructure and transaction-processing systems. Capacity constraints or system failures would harm our business, prospects, results of operations and financial condition.**

Any system interruptions that result in the unavailability of our Website or reduced performance of our transaction systems would reduce our transaction volume and the attractiveness of the services that we provide to suppliers and third parties and would harm our business, prospects, operating results and financial condition.

We use internally developed systems for our Website and certain aspects of transaction processing, including customer profiling and order verifications. We have experienced periodic systems interruptions due to server failure, which we believe will continue to occur from time to time. If the volume of traffic on our Website or the number of purchases made by customers substantially increases, we will need to further expand and upgrade our technology, transaction processing systems and network infrastructure. We have experienced and expect to continue to experience temporary capacity constraints due to sharply increased traffic during sales or other promotions and during the holiday shopping season. Capacity constraints can cause unanticipated system disruptions, slower response times, and degradation in levels of customer service, impaired quality and delays in reporting accurate financial information.

Our transaction processing systems and network infrastructure may be unable to accommodate increases in traffic in the future. We may be unable to project accurately the rate or timing of traffic increases or successfully upgrade our systems and infrastructure to accommodate future traffic levels on our Website. In addition, we may be unable to upgrade and expand our transaction processing systems in an effective and timely manner or to integrate any newly developed or purchased functionality with our existing systems. For example, in the third quarter 2005 we experienced difficulties with our implementation of infrastructure upgrades, which resulted in our inability to upload new products to our Website for a period of approximately five weeks. Any such difficulties with our transaction processing systems or other difficulties upgrading, expanding or integrating various aspects of our systems may cause unanticipated system disruptions, slower response times, and degradation in levels of customer service, additional expense, impaired quality and speed of order fulfillment or delays in reporting accurate financial information.

**If the facility where substantially all of our computer and communications hardware is located fails, our business, results of operations and financial condition will be harmed.**

Our success, and in particular, our ability to successfully receive and fulfill orders and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of our computer and communications hardware is located at a single co-location facility in Salt Lake City, Utah, with a partially redundant back-up system located near our corporate headquarters in Salt Lake City. Although we have designed our back-up system in an effort to avoid or minimize service interruptions in the event of a failure of our main facility, our systems and operations are vulnerable to damage or interruption from fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. Our disaster recovery plan may be inadequate, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Despite the implementation of network security measures, our servers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays, loss of critical data or the inability to accept and fulfill customer orders. The occurrence of any of the foregoing risks could harm our business, prospects, financial condition and results of operations.

**We may be unable to protect our proprietary technology or keep up with that of our competitors.**

Our success depends to a significant degree upon the protection of our software and other proprietary intellectual property rights. We may be unable to deter misappropriation of our proprietary information, detect unauthorized use and take appropriate steps to enforce our intellectual property rights. In addition, our competitors could, without violating our proprietary rights, develop technologies that are as good as or better than our technology.

Our failure to protect our software and other proprietary intellectual property rights or to develop technologies that are as good as our competitors could put us at a disadvantage to our competitors. In addition, the failure of the third parties whose

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products we offer for sale on our Website to protect their intellectual property rights, including their domain names, could impair our operations. These failures could harm our business, results of operations and financial condition.

**If we do not respond to rapid technological changes, our services could become obsolete and we could lose customers.**

To remain competitive, we must continue to enhance and improve the functionality and features of our e-commerce businesses. We may face material delays in introducing new services, products and enhancements. If this happens, our customers may forgo the use of our Website and use those of our competitors. The Internet and the online commerce industry are rapidly changing. If competitors introduce new products and services using new technologies or if new industry standards and practices emerge, our existing Website and our proprietary technology and systems may become obsolete. Our failure to respond to technological change or to adequately maintain, upgrade and develop our computer network and the systems used to process customers' orders and payments could harm our business, prospects, financial condition and results of operations.

**We may not be able to obtain trademark protection for our marks, which could impede our efforts to build brand identity.**

We have filed trademark applications with the Patent and Trademark Office seeking registration of certain service marks and trademarks. There can be no assurance that our applications will be successful or that we will be able to secure significant protection for our service marks or trademarks in the United States or elsewhere as we expand internationally. Our competitors or others could adopt product or service marks similar to our marks, or try to prevent us from using our marks, thereby impeding our ability to build brand identity and possibly leading to customer confusion. Any claim by another party against us or customer confusion related to our trademarks, or our failure to obtain trademark registration, could negatively affect our business.

**We may not be able to enforce protection of our intellectual property rights under the laws of other countries.**

As we continue to expand internationally, we are subject to risks of doing business internationally as related to our intellectual property, including:

legal uncertainty regarding liability for the listings and other content provided by our users, including uncertainty as a result of less Internet-friendly legal systems, unique local laws, and lack of clear precedent or applicable law; and

differing intellectual property laws, which may provide insufficient protection for our intellectual property.

**Our business and reputation may be harmed by the listing or sale of pirated, counterfeit or illegal items by third parties, and by intellectual property litigation.**

We have received in the past, and we anticipate we will receive in the future, communications alleging that certain items listed or sold through our Website infringe third-party copyrights, trademarks and trade names or other intellectual property rights or that we have otherwise infringed third parties' past, current or future intellectual property rights.

We may be unable to prevent third parties from listing unlawful goods, and we may be subject to allegations of civil or criminal liability for unlawful activities carried out by third parties through our Website. In the future, we may implement measures to protect against these potential liabilities that could require us to spend substantial resources and/or to reduce revenues by discontinuing certain service offerings. Any costs incurred as a result of liability or asserted liability relating to the sale of unlawful goods or the unlawful sale of goods could harm our revenues, business, prospects, financial condition and results of operations.

Resolving litigation or claims regarding patents or other intellectual property, whether meritorious or not, could be costly, time-consuming, cause service delays, divert our management and key personnel from our business operations, require expensive or unwanted changes in our methods of doing business or require us to enter into costly royalty or licensing agreements, if available. As a result, these claims could harm our business.

Negative publicity generated as a result of the foregoing could damage our reputation, harm our business and diminish the value of our brand name.

**Our Gradient Analytics and Rocker Partners, L.P. litigation may have an adverse effect on our business and financial condition.**

In August 2005 we filed an unfair business practice lawsuit against Gradient Analytics, Rocker Partners, L.P. and others, alleging that the defendants have conspired to denigrate Overstock's business for personal profit. In October 2005 we filed an amended complaint alleging additional causes of action and articulating in greater detail the allegations against the defendants. Overstock's Chief Executive Officer, Dr. Patrick Byrne, has appeared on nationally syndicated television programs and elsewhere to discuss the litigation. The use of management's time and attention in connection with the litigation and related matters may reduce the time management is able to spend on other aspects of our business, which may have adverse effects on other aspects of our business. To the extent that any such adverse effects exceed any benefits we may realize from pursuing the litigation, our business, prospects, financial condition and results of operation may suffer.

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**Our Prime Broker litigation may have an adverse effect on our business and financial condition.**

In February 2007, along with five shareholder plaintiffs, we filed a lawsuit in the Superior Court of California, County of San Francisco against Morgan Stanley & Co. Incorporated, Goldman Sachs & Co., Bear Stearns Companies, Inc., Bank of America Securities LLC, Bank of New York, Citigroup Inc., Credit Suisse (USA) Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., and UBS Financial Services, Inc. The use of management's time and attention in connection with the litigation and related matters may reduce the time management is able to spend on other aspects of our business, which may have adverse effects on other aspects of our business. To the extent that any such adverse effects exceed any benefits we may realize from pursuing the litigation, our business, prospects, financial condition and results of operation may suffer.

**We may be liable if third parties misappropriate our customers' personal information.**

If third parties are able to penetrate our network security or otherwise misappropriate our customers' personal information or credit card information, or if we give third parties improper access to our customers' personal information or credit card information, we could be subject to liability. This liability could include claims for unauthorized purchases with credit card information, impersonation or other similar fraud claims or damages for alleged violations of state or federal laws governing security protocols for the safekeeping of customers' personal or credit card information. This liability could also include claims for other misuses of personal information, including unauthorized marketing purposes. These claims could result in litigation. Liability for misappropriation of this information could adversely affect our business. In addition, the Federal Trade Commission and state agencies have been investigating various Internet companies regarding their use of personal information. We could incur additional expenses if new regulations regarding the use of personal information are introduced or if government agencies investigate our privacy practices.

We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary to effect secure transmission of confidential information such as customer credit card numbers. We cannot assure you that advances in computer capabilities, new discoveries in the field of cryptography or other events or developments will not result in a compromise or breach of the algorithms that we use to protect customer transaction data. If any such compromise of our security were to occur, it could harm our reputation, business, prospects, financial condition and results of operations. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches. We cannot assure you that our security measures will prevent security breaches or that failure to prevent such security breaches will not harm our business, prospects, financial condition and results of operations.

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

We sell products manufactured for us by third parties, some of which may be defective. If any product that we sell were to cause physical injury or injury to property, the injured party or parties could bring claims against us as the manufacturer and/or retailer of the product. Our insurance coverage may not be adequate to cover every claim that could be asserted. If a successful claim were brought against us in excess of our insurance coverage, it could adversely affect our business. Even unsuccessful claims could result in the expenditure of funds and management time and could have a negative impact on our business.

**The promissory notes we hold in connection with the sale of our travel business are risky.**

As part of the sale of our travel business, we now hold senior and junior promissory notes issued by the purchaser. Both of these notes have a stated amount of \$3,000,000. The security on the senior note is the stock of the travel company we sold. There is no security on the junior note, which note also may be subordinated to all other debt of the travel company, and, according to the junior note terms, is not in default so long as the senior debt is outstanding. In the event of default on one or both of these notes, it is possible that stock held as security on the note will have lost some or all of its value. If the purchaser defaults on one or both of these notes, and we are unable to collect or realize comparable value by foreclosing on the stock held as security, the notes could have little or no value.

**We have significant indebtedness.**

In connection with our sale of our 3.75% Convertible Senior Notes (the Senior Notes ) in November 2004, we incurred \$120.0 million of indebtedness, due December 1, 2011. Under the repurchase program approved by our Board of Directors in 2005, we retired \$33.0 million and \$10.0 million of the Senior Notes in June and November 2005 for \$27.9 million and \$7.8 million in cash, respectively. As a result of the note retirements, we recognized a gain of \$6.2 million for the year ended December 31, 2005, net of the associated unamortized discount of \$1.2 million. As of September 30, 2007, \$77.0 million of the Senior Notes remained outstanding. As a result of this indebtedness, our principal and interest payment obligations increased substantially. The degree to which we are leveraged could materially and adversely affect our ability to obtain additional financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. Our ability to meet our debt service obligations is dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control.

**We may be unable to generate sufficient cash flow to satisfy our debt service obligations.**

Our ability to generate cash flow from operations to make interest payments on our debt obligations will depend on our

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future performance, which will be affected by a range of economic, competitive and business factors. We cannot control many of these factors, including general economic conditions and the health of the internet retail industry. If our operations do not generate sufficient cash flow from operations to satisfy our debt service obligations, we may need to borrow additional funds to make these payments or undertake alternative financing plans, such as refinancing or restructuring our debt, or reducing or delaying capital investments and acquisitions. Additional funds or alternative financing may not be available to us on favorable terms, or at all. Our inability to generate sufficient cash flow from operations or obtain additional funds or alternative financing on acceptable terms could have a material adverse effect on our business, prospects, financial condition and results of operations.

### **Risks Relating to our Auctions Site Business**

#### **Our auctions business may be subject to a variety of regulatory requirements.**

Many states and other jurisdictions, including Utah, where our company is located, have regulations governing the conduct of traditional auctions and the liability of traditional auctioneers in conducting auctions. Although the vast majority of these regulations clearly contemplated only traditional auctions, not online auctions, the potential application of these types of regulations to online auction sites is not clear. We are aware that several states and some foreign jurisdictions have attempted to impose such regulations on other companies operating online auction sites or on the users of those sites. In addition, certain states have laws or regulations that do expressly apply to online auction site services. Although we do not expect these laws to have a significant effect on our auction site business, we will incur costs in complying with these laws, and we may from time to time be required to make changes in our business that may increase our costs, reduce our revenues, cause us to prohibit the listing of certain items in certain locations, or make other changes that may adversely affect our auctions business.

#### **Current and future laws could affect our auctions business.**

Like our shopping site business, our auction site business is subject to the same laws and regulations that apply to other companies conducting business on and off the Internet. In addition, our auction site business may be affected by other laws and regulations, such as those that expressly apply to online auction site services. Further, because of the wide range of items that users of our auctions service may choose to list on the site, a variety of additional laws and regulations may apply to transactions between users of our site, such as those requiring a license to sell or purchase certain items or mandating particular disclosures in connection with an offer or sale of an item. To the extent that such current or future laws or regulations prevent users from selling items on our auction site, they could harm our business.

#### **Our business may be harmed if our auction site is used for unlawful transactions.**

The law regarding the potential liability of an online auction service for the activities of its users is not clear. We prohibit the listing of numerous categories of items in an effort to reduce the possibility that users of our auction site will engage in an unlawful transaction. However, we cannot assure that users of the site will comply with all laws and regulations applicable to them and their transactions, and we may be subject to allegations of civil or criminal liability for any unlawful activities conducted by them. Any costs we incur as a result of any such allegations, as a result of actual or alleged unlawful transactions utilizing our site, or in our efforts to prevent any such transactions, may harm our business. In addition, any negative publicity we receive regarding any such transactions or allegations may damage our reputation, our ability to attract new customers to our main shopping site, and the Overstock.com brand name generally.

**Fraudulent activities using our auctions site and disputes between users of our auctions site may harm our business.**

We are aware that other companies operating online auction services have periodically received complaints from users alleging that they have not received the purchase price or the goods they expected to receive and that, in some cases, users have been arrested and convicted for engaging in fraudulent activities using those companies' auction sites. We may receive similar complaints. We do not have the ability to require users of our services to fulfill their obligations to make payments or to deliver items. We are aware that other companies periodically receive complaints from buyers about the quality of the items they purchase, requests for reimbursement of amounts paid, and communications threatening or commencing legal actions against them. We may receive similar complaints, requests and communications in connection with our auctions site business.

**We are subject to risks associated with information transmitted through our auctions service.**

The law relating to the liability of online services companies for information carried on or disseminated through their services is currently unsettled. Claims could be made against online services companies under both U.S. and foreign law for defamation, libel, invasion of privacy, negligence, copyright or trademark infringement, or other theories based on the nature and content of the materials disseminated through their services. We are aware that private lawsuits seeking to impose liability under a number of these theories have been brought against other companies operating auction sites. In addition, domestic and foreign legislation has been proposed that would prohibit or impose liability for the transmission over the Internet of certain types of information. Our auctions service permits users to make comments regarding other users. Although all such comments are generated by users and not by us, we are aware that claims of defamation or other injury have been made against other companies operating auction services in the past and could be made in the future against us for comments made by users. Recent court decisions have narrowed the scope of the immunity provided to Internet service providers like us under the Communications Decency Act. This trend, if continued, may increase our potential liability to third parties for the user-provided content on our site.

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**Difficulties or negative publicity associated with our auctions business could affect our main shopping site business.**

Any significant operational or other difficulties we encounter with our auctions business could damage our reputation, our ability to attract new customers to our main shopping site, and the Overstock.com brand name generally. Negative publicity resulting from actual or alleged fraudulent or deceptive conduct by users of our auctions site could also damage our reputation, our ability to attract new customers to our main shopping site, and the Overstock.com brand name generally.

**Risks Relating to our Cars Site Business**

**Our cars site is a new business.**

Our car listing site began operation in December 2006. The car listing site is a listing service for automobile sellers. The online car listing service is a new business for us. We cannot ensure that our expansion into the car listing business will succeed. Our entry into this business will require us to devote substantial financial, technical, managerial and other resources to this car listing site. It will also expose us to additional risks, including legal and regulatory risks, and it will require us to compete with established businesses having substantially greater experience in the online car listing service business and substantially greater resources than we have.

**Our car listing business may be subject to a variety of regulatory requirements.**

Many states and other jurisdictions, including Utah, where we are located, have regulations governing the conduct of car sellers and public advertisement for car sales. Generally, these regulations govern the conduct of those sellers advertising their automobiles for sale and are not directly applicable to those providing the medium through which the advertisement is made available to the public. Sellers are often subject to regulations in the nature of truth in advertising laws. The application of these regulations to online car listing service providers is not clear. Although we do not expect these laws to have a significant effect on our car listing business, we will incur costs in researching and complying with these laws, and we may from time to time be required to make changes in our business that may increase our costs, reduce our revenues, cause us to prohibit certain listing or advertising practices, or make other changes that may adversely affect our car listing business.

**Current and future laws could affect our car listing business.**

Like our shopping site business, our car listing business is subject to the same laws and regulations that apply to other companies conducting business on and off the Internet. In addition, our car listing business may be affected by other laws and regulations, such as those that expressly apply to advertising automobiles for sale. To the extent that such current or future laws or regulations prevent users from selling items on our car listing site, they could harm our business.

**Our business may be harmed if our car listing site is used for unlawful transactions.**

The law regarding the potential liability of an online listing service for automobile sales is not clear. The platform of the listing service will be accessible to those subscribers who will have the ability to feature their cars for sale and will supply the text descriptions of the vehicles, including the general condition of the vehicle and other important information. We will have no ability beforehand to know if the information sellers provide is correct. While our site terms and conditions of usage will prohibit unlawful acts, we cannot rule out the possibility that users of our car listing site will engage in unlawful transactions, or fail to comply with all laws and regulations applicable to them and their transactions. We may be subject to allegations of civil or criminal liability for any unlawful activities conducted by such users. Any costs we incur as a result of any such allegations, as a result of actual or alleged unlawful transactions utilizing our site, or in our efforts to prevent any such transactions, may harm our business. In addition, any negative publicity we receive regarding any such transactions or allegations may damage our reputation, our ability to attract new customers to our main shopping site, and the Overstock.com brand name generally.

**Fraudulent activities using our car listing site and disputes between users of our car listing site may harm our business.**

We are aware that other companies operating online car listing services have periodically received complaints from users alleging improprieties in connection with listings and occasionally these complaints may result in regulatory action. Particularly, with any online listing service there is the possibility that sellers may attempt to employ bait and switch techniques, attracting consumers with advertisements of low cost, good condition vehicles in hopes of switching buyer interest to another less favorable vehicle once a potential purchaser responds. Additionally, sellers may attempt to sell vehicles without accurate descriptions of the condition of the vehicles. We do not have the ability to require users of our services to fulfill their obligations to make accurate disclosures or comply with consumer laws prohibiting bait and switch or other prohibited seller tactics. We are aware that other companies providing similar services periodically receive complaints from vehicle purchasers about the quality of the vehicles they purchase, requesting reimbursement of amounts they have paid, threatening or commencing legal actions against the listing service for damages. We may receive similar complaints, requests and communications, and encounter similar legal actions in connection with our cars listing business, which may harm our business or reputation among consumers.

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**Risks Relating to our Community Site Business.**

Our Community site began operation in February 2006 with the introduction of Omuse, an Overstock supported, collaborative writing platform. Omuse allows Community site users to read about and or write guides about a universe of subjects in which they may have a particular expertise or interest. The Community site when fully deployed will also have services intended to establish user forum participation, provide customers access to recent news about Overstock and allow users the opportunity to participate in forum reading and writing, to create weblogs or post comments to the weblogs or blogs of other site users, or in our Omuse collaborative writing platform. Presently Omuse is the only operating platform on the Community site. The Community site is a new business for us. We cannot ensure that our expansion into this business will succeed. It is a business which allows persons to contribute content within certain guidelines and subject to terms and conditions. We cannot always be in a position to assure that our community users are abiding by these terms and conditions, or be in a position to interdict or remove inappropriate or infringing material. Our entry into this business will require us to devote substantial financial, technical, managerial and other resources to this site. It is uncertain whether the business will benefit financially from the Community site. The Community site will also expose us to additional risks, including legal and regulatory risks, including, but not limited to, legal actions for possible intellectual property infringement, and claims for libel. Additionally, our entry into the Community site service will require us to compete with established businesses having substantially greater experience in the Community site service business and which have substantially greater resources than we have.

**Risks Relating to the Internet Industry**

**Our success is tied to the continued use of the Internet and the adequacy of the Internet infrastructure.**

Our future revenues and profits, if any, substantially depend upon the continued widespread use of the Internet as an effective medium of business and communication. Factors which could reduce the widespread use of the Internet include:

actual or perceived lack of security of information or privacy protection;

possible disruptions, computer viruses or other damage to the Internet servers or to users' computers; and

governmental regulation.

**Customers may be unwilling to use the Internet to purchase goods.**

Our long-term future depends heavily upon the general public's willingness to use the Internet as a means to purchase goods. E-commerce remains a relatively new concept and large numbers of customers may not begin or continue to use the Internet to purchase goods. The demand for and acceptance of products sold over the Internet are highly uncertain and most e-commerce businesses have a short track record. If consumers are unwilling to use the Internet to conduct business, our business may not develop profitably.

**The security risks or perception of risks of e-commerce may discourage customers from purchasing goods from us.**

In order for the e-commerce market to develop successfully, we 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 our Website and choose not to purchase from our Website. If someone is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Concerns about the security and privacy of transactions over the Internet could inhibit the growth of the Internet and e-commerce. Our security measures may not effectively prohibit others from obtaining improper access to our information. Third parties may target our customers directly with fraudulent identity theft schemes designed to appear as legitimate communications from us. Any security breach or fraud perpetrated on our customers could expose us to increased costs and to risks of loss, litigation and liability and could seriously disrupt our operations.

**Credit card fraud could adversely affect our business.**

We do not carry insurance against the risk of credit card fraud, so the failure to adequately control fraudulent credit card transactions could reduce our net revenues and our gross margin. We have implemented technology to help us detect the fraudulent use of credit card information. However, we 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, we may be liable for fraudulent credit card transactions because we do not obtain a cardholder's signature. If we are unable to detect or control credit card fraud, our liability for these transactions could harm our business, results of operation or financial condition.

**If one or more states successfully assert that we should collect sales or other taxes on the sale of our merchandise or the merchandise of third parties that we offer for sale on our Website, our business could be harmed.**

We do not currently collect sales or other similar taxes for physical shipments of goods into states other than Utah and Indiana. One or more local, state or foreign jurisdictions may seek to impose sales tax collection obligations on us and other out-of-state companies that engage in online commerce. Our business could be adversely affected if one or more states or any foreign country successfully asserts that we should collect sales or other taxes on the sale of our merchandise.

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**Existing or future government regulation could harm our business.**

We are subject to the same federal, state and local laws as other companies conducting business on the Internet. Today there are relatively few laws specifically directed towards conducting business on the Internet. However, due to the increasing popularity and use of the Internet, many laws and regulations relating to the Internet are being debated at the state and federal levels. These laws and regulations could cover issues such as user privacy, freedom of expression, pricing, fraud, quality of products and services, taxation, advertising, intellectual property rights and information security. Applicability to the Internet of existing laws governing issues such as property ownership, copyrights and other intellectual property issues, taxation, libel, obscenity and personal privacy could also harm our business. For example, United States and foreign laws regulate our ability to use customer information and to develop, buy and sell mailing lists. The vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised thereby. Those laws that do reference the Internet are only beginning to be interpreted by the courts and their applicability and reach are therefore uncertain. These current and future laws and regulations could harm our business, results of operation and financial condition.

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

We are subject to increasing regulation at the federal, state and international levels relating to privacy and the use of personal user information. For example, we are subject to various telemarketing laws that regulate the manner in which we may solicit future suppliers and customers. Such regulations, along with increased governmental or private enforcement, may increase the cost of growing our business. In addition, many jurisdictions have laws that limit the uses of personal user information gathered online or offline or require companies to establish privacy policies. The Federal Trade Commission has adopted regulations regarding the collection and use of personal identifying information obtained from children under 13. Proposed legislation in this country and existing laws in foreign countries require companies to establish procedures to notify users of privacy and security policies, obtain consent from users for collection and use of personal information, and/or provide users with the ability to access, correct and delete personal information stored by us. Additional legislation regarding data security and privacy has been proposed in Congress. These data protection regulations may restrict our ability to collect demographic and personal information from users, which could be costly or harm our marketing efforts, and could require us to implement new and potentially costly processes, procedures and/or protective measures.

**Risks Relating to the Securities Markets and Ownership of Our Securities**

**The price of our securities may be volatile and you may lose all or a part of your investment.**

Our common stock has been publicly traded only since May 30, 2002. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. These fluctuations could continue. It is possible that in some future periods our results of operations may be below the expectations of public market analysts and investors. If this occurs, the market price of our securities may decline. Some of the factors that could affect the market price of our securities are as follows:

changes in securities analysts' recommendations or estimates of our financial performance or publication of research reports by analysts;

changes in market valuations of similar companies;

announcements by us or our competitors of significant contracts, acquisitions, commercial relationships, joint ventures or capital commitments;

general market conditions;

actual or anticipated fluctuations in our operating results;

intellectual property or litigation developments;

changes in our management team;

economic factors unrelated to our performance; and

our issuance of additional shares of stock or other securities.

In addition, the securities markets have experienced significant price and trading volume fluctuations. These broad market fluctuations may adversely affect the trading price of our securities. In the past, following periods of volatility in the market price of a public company's securities, securities class action litigation has often been instituted against that company. Such litigation could result in substantial cost and a diversion of management's attention and resources.

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**Our quarterly operating results are volatile and may adversely affect the market price of our securities.**

Our future revenues and operating results are likely to vary significantly from quarter to quarter due to a number of factors, many of which are outside our control, and any of which could harm our business. As a result, we believe that quarterly comparisons of our operating results are not necessarily meaningful and that you should not rely on the results of one quarter as an indication of our future performance. In addition to the other risk factors described in this report, additional factors that have caused and/or could cause our quarterly operating results to fluctuate and in turn affect the market price of our securities include:

increases in the cost of advertising;

our inability to retain existing customers or encourage repeat purchases;

the extent to which our existing and future marketing agreements are successful;

price competition that results in lower profit margins or losses;

the amount and timing of operating costs and capital expenditures relating to the expansion of our business operations and infrastructure;

the amount and timing of our purchases of inventory;

our inability to manage distribution operations or provide adequate levels of customer service;

our ability to successfully integrate operations and technologies from acquisitions or other business combinations;

entering into new lines of products;

our ability to attract users to our new auctions and car listing sites; and

our inability to replace the loss of significant customers.

**Our operating results may fluctuate depending on the season, and such fluctuations may affect the market price of our securities.**

We have experienced and expect to continue to experience fluctuations in our operating results because of seasonal fluctuations in traditional retail patterns. Sales in the retail and wholesale industry tend to be significantly higher in the fourth calendar quarter of each year than in the preceding three quarters due primarily to increased shopping activity during the holiday season. However, there can be no assurance that our sales in the fourth quarter will exceed those of the preceding quarters or, if the fourth quarter sales do exceed those of the preceding quarters, that we will be able to manage the increased sales effectively. Further, we generally increase our inventories substantially in anticipation of holiday season shopping activity, which has a negative effect on our cash flow. Securities analysts and investors may inaccurately estimate the effects of seasonality on our results of operations in one or more future quarters and, consequently, our operating results may fall below expectations, causing the market price of our securities to decline.

**We do not intend to pay dividends on our non-redeemable common stock and you may lose the entire amount of your investment in our common stock.**

We have never declared or paid any cash dividends on our non-redeemable common stock and do not intend to pay dividends on our non-redeemable common stock for the foreseeable future. We intend to invest our future earnings, if any, to fund our growth. Therefore, you will not receive any funds without selling your shares. We cannot assure that you will receive a positive return on your investment when you sell your shares or that you will not lose the entire amount of your investment.

**Our Amended and Restated Certificate of Incorporation, Amended and Restated Bylaws and the Delaware General Corporation Law contain anti-takeover provisions which could discourage or prevent a takeover, even if an acquisition would be beneficial to our stockholders.**

Several provisions of our Amended and Restated Certificate of Incorporation and Amended and Restated Bylaws could discourage potential acquisition proposals and could delay or prevent a change in control of our company even if that change in control would be beneficial to our stockholders. For example, only one-third of our board of directors will be elected at each of our annual meetings of stockholders, which will make it more difficult for a potential acquirer to change the management of our company, even after acquiring a majority of the shares of our common stock. These provisions, which cannot be amended without the approval of two-thirds of our stockholders, could diminish the opportunities for a stockholder to participate in tender offers, including tender offers at a price above the then current market value of our common stock. In addition, our board of directors, without further stockholder approval, may issue preferred stock, with such terms as the board of directors may determine, that could have the effect of delaying or preventing a change in control of our company. The issuance of preferred stock could also adversely affect the voting powers of the holders of common stock, including the loss of voting control to others. We are also afforded the protections of Section 203 of the Delaware General Corporation Law, which could delay or prevent a change in



control of our company or could impede a merger, consolidation, takeover or other business combination involving our company or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of our company.

**The price of our stock may be vulnerable to manipulation.**

We have filed an unfair business practice lawsuit against Gradient Analytics, Rocker Partners, L.P. and others, alleging that the defendants have conspired to denigrate Overstock's business for personal profit, as well as an amended complaint alleging additional causes of action and articulating in greater detail the allegations against the defendants. We have also filed an unfair business practice lawsuit against Morgan Stanley & Co. Incorporated, Goldman Sachs & Co., Bear Stearns Companies, Inc., Bank of America Securities LLC, Bank of New York, Citigroup Inc., Credit Suisse (USA) Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., UBS Financial Services, Inc and Lehman Brothers Holding Inc. In September 2007, we filed an amended complaint adding Lehman Brothers, Inc. as an additional defendant and articulating in greater detail the allegations against the defendants. We believe that the defendants in both of these lawsuits have engaged in unlawful actions and have caused substantial harm to Overstock, and that certain of the defendants have made efforts to drive the market price of Overstock's common stock down. To the extent that the defendants or other persons engage in any such actions or other take any other actions to interfere with or destroy or harm Overstock's existing and/or prospective business relationships with its suppliers, bankers, customers, lenders, investors, prospective investors or others, our business, prospects, financial condition and results of operation may suffer, and the price of our common stock may be more volatile than it might otherwise be and/or may trade at prices below those that might prevail in the absence of any such efforts.

Any investment in our securities involves a high degree of risk. Investors should consider carefully the risks and uncertainties described above, and all other information in this Form 10-Q and in any reports we file with the SEC after we file this Form 10-Q, before deciding whether to purchase or hold our securities. Additional risks and uncertainties not currently known to us or that we currently deem immaterial may also become important factors that may harm our business. The occurrence of any of the risks described in this Form 10-Q could harm our business. The trading price of our securities could decline due to any of these risks and uncertainties, and investors may lose part or all of their investment.

**Available Information**

Our Internet website address is <http://www.overstock.com>. Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge through our Internet website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The address of that site is <http://www.sec.gov>. Our Internet website and the information contained therein or connected thereto are not a part of or incorporated into this Quarterly Report on Form 10-Q.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) Exhibits

31	Rule 13a-15(d)/15d-15(d) Certifications
32	Section 1350 Certifications

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**SIGNATURE**

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

**OVERSTOCK.COM, INC.**

/s/ David K. Chidester  
David K. Chidester  
Senior Vice President, Finance

Dated: November 7, 2007

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