

PFSWEB INC
Form 10-K/A
April 04, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K/A

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

For the fiscal year ended December 31, 2005

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 000-28275

PFSWEB, INC.

(Exact name of registrant as specified in its charter)

Delaware

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

500 North Central Expressway, Plano, Texas

(Address of principal executive offices)

75-2837058

*(I.R.S. Employer
Identification Number)*

75074

(Zip code)

Registrant's telephone number, including area code:

972-881-2900

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.001 per share

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No

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

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 Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2005 (based on the closing price as reported by the National Association of Securities Dealers Automated Quotation System) was \$38,419,950.

As of March 21, 2006, there were 41,399,837 shares of the registrant's Common Stock, \$.001 par value, outstanding, excluding 86,300 shares of common stock in treasury.

EXPLANATORY NOTE

This Report is filed to solely for the purpose of including the signature of KPMG LLP in its opinion and consent which, through a typographical error, was not contained in the Company s prior filing.

Item 8. Financial Statements and Supplementary Data

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND
FINANCIAL STATEMENT SCHEDULES**

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of
PFSweb, Inc.:

We have audited the accompanying consolidated balance sheets of PFSweb, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss) and cash flows for each of the years in the three-year period ended December 31, 2005. In connection with our audits of the consolidated financial statements, we also have audited the accompanying financial statement schedules as of December 31, 2005 and 2004, and for each of the years in the three-year period ended December 31, 2005.

These consolidated financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PFSweb, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules as of December 31, 2005 and 2004, and for each of the years in the three-year period ended December 31, 2005, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

KPMG LLP

Dallas, Texas

February 24, 2006, except for Notes 3 and 4 as to which the date is March 31, 2006

PFSWEB, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

| | December 31, 2005 | December 31, 2004 |
|--|----------------------------------|----------------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 13,683 | \$ 13,592 |
| Restricted cash | 2,077 | 2,746 |
| Accounts receivable, net of allowance for doubtful accounts of \$484 and \$504 at December 31, 2005 and 2004, respectively | 44,556 | 41,565 |
| Inventories, net | 43,654 | 44,947 |
| Other receivables | 9,866 | 8,061 |
| Prepaid expenses and other current assets | 3,213 | 3,349 |
| Total current assets | 117,049 | 114,260 |
| | | |
| PROPERTY AND EQUIPMENT, net | 13,040 | 14,264 |
| RESTRICTED CASH | 150 | 675 |
| OTHER ASSETS | 1,487 | 1,128 |
| | | |
| Total assets | \$ 131,726 | \$ 130,327 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt and capital lease obligations | \$ 21,626 | \$ 19,098 |
| Trade accounts payable | 60,053 | 61,583 |
| Accrued expenses | 12,011 | 10,971 |
| Total current liabilities | 93,690 | 91,652 |
| | | |
| LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion | 6,289 | 7,232 |
| OTHER LIABILITIES | 1,813 | 1,517 |
| COMMITMENTS AND CONTINGENCIES | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued and outstanding | ¾ | ¾ |
| Common stock, \$0.001 par value; 40,000,000 shares authorized; 22,613,314 and 21,665,585 shares issued at December 31, 2005 and 2004, respectively; and 22,527,014 and 21,579,285 outstanding at December 31, 2005 and 2004, | 23 | 22 |

respectively

| | | |
|--|------------|------------|
| Additional paid-in capital | 58,736 | 56,645 |
| Accumulated deficit | (29,824) | (29,077) |
| Accumulated other comprehensive income | 1,084 | 2,421 |
| Treasury stock at cost, 86,300 shares | (85) | (85) |
| | | |
| Total shareholders' equity | 29,934 | 29,926 |
| | | |
| Total liabilities and shareholders' equity | \$ 131,726 | \$ 130,327 |

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

PFSWEB, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31
(In thousands, except per share data)

| | 2005 | 2004 | 2003 |
|---|-----------------|----------------|-------------------|
| REVENUES: | | | |
| Product revenue, net | \$ 252,902 | \$ 267,470 | \$ 249,230 |
| Service fee revenue | 60,783 | 42,076 | 33,771 |
| Pass-through revenue | 17,972 | 12,119 | 3,435 |
| Total revenues | 331,657 | 321,665 | 286,436 |
| COSTS OF REVENUES: | | | |
| Cost of product revenue | 235,584 | 251,968 | 235,317 |
| Cost of service fee revenue | 45,597 | 28,067 | 23,159 |
| Cost of pass-through revenue | 17,972 | 12,119 | 3,435 |
| Total costs of revenues | 299,153 | 292,154 | 261,911 |
| Gross profit | 32,504 | 29,511 | 24,525 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 30,521 | 27,091 | 25,699 |
| Income (loss) from operations | 1,983 | 2,420 | (1,174) |
| INTEREST EXPENSE | 1,824 | 1,590 | 2,124 |
| INTEREST INCOME | (95) | (130) | (124) |
| Income (loss) before income taxes | 254 | 960 | (3,174) |
| INCOME TAX EXPENSE | 1,001 | 734 | 572 |
| NET INCOME (LOSS) | \$ (747) | \$ 226 | \$ (3,746) |
| EARNINGS (LOSS) PER SHARE: | | | |
| Basic | \$ (0.03) | \$ 0.01 | \$ (0.20) |
| Diluted | \$ (0.03) | \$ 0.01 | \$ (0.20) |
| WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING: | | | |
| Basic | 22,394 | 21,332 | 19,011 |
| Diluted | 22,394 | 23,468 | 19,011 |

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

PFSWEB, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND
COMPREHENSIVE INCOME (LOSS)

(In thousands, except share data)

| | Common Stock | | Additional | Accumulated | Other | Treasury | Total Comprehensive | | |
|--|--------------|--------|-----------------|---------------------|-----------------------------|--------------|---------------------|---------------------|---------------|
| | Shares | Amount | Paid-In Capital | Accumulated Deficit | Comprehensive Income (Loss) | Stock Shares | Amount | Shareholders Equity | Income (Loss) |
| Balance, December 31, 2002 | 18,397,983 | \$ 18 | \$ 52,094 | \$ (25,557) | \$ | 86,300 | \$ (85) | \$ 26,470 | |
| Net loss | | | | (3,746) | | | | (3,746) | \$ (3,746) |
| Stock based compensation expense | | | 6 | | | | | 6 | |
| Employee stock purchase plan | 618,446 | 1 | 261 | | | | | 262 | |
| Proceeds from exercised options | 649,568 | 1 | 618 | | | | | 619 | |
| Private placement of common stock | 1,581,944 | 1 | 3,177 | | | | | 3,178 | |
| Other comprehensive income foreign currency translation adjustment | | | | | 1,628 | | | 1,628 | 1,628 |
| Comprehensive loss | | | | | | | | | \$ (2,118) |
| Balance, December 31, 2003 | 21,247,941 | \$ 21 | \$ 56,156 | \$ (29,303) | \$ 1,628 | 86,300 | \$ (85) | \$ 28,417 | |
| Net income | | | | 226 | | | | 226 | \$ 226 |
| Stock based compensation expense | | | 14 | | | | | 14 | |
| Employee stock purchase plan | 226,381 | 1 | 316 | | | | | 317 | |
| Proceeds from exercised options | 191,263 | | 159 | | | | | 159 | |
| | | | | | 793 | | | 793 | 793 |

Other
comprehensive
income foreign
currency
translation
adjustment

Comprehensive
income \$ 1,019

| | | | | | | | | | |
|---|------------|-------|-----------|-------------|----------|--------|---------|-----------|------------|
| Balance, December 31, 2004 | 21,665,585 | \$ 22 | \$ 56,645 | \$ (29,077) | \$ 2,421 | 86,300 | \$ (85) | \$ 29,926 | |
| Net loss | | | | (747) | | | | (747) | \$ (747) |
| Stock based compensation Expense | | | 16 | | | | | 16 | |
| Employee stock purchase plan | 401,270 | | 613 | | | | | 613 | |
| Proceeds from exercised options | 151,774 | | 181 | | | | | 181 | |
| Warrants exercised | 394,385 | 1 | 1,281 | | | | | 1,282 | |
| Other comprehensive loss foreign currency translation adjustment | | | | | (1,337) | | | (1,337) | (1,337) |
| Comprehensive loss | | | | | | | | | \$ (2,084) |

| | | | | | | | | | |
|----------------------------------|------------|-------|-----------|-------------|----------|--------|---------|-----------|--|
| Balance, December 31, 2005 | 22,613,014 | \$ 23 | \$ 58,736 | \$ (29,824) | \$ 1,084 | 86,300 | \$ (85) | \$ 29,934 | |
|----------------------------------|------------|-------|-----------|-------------|----------|--------|---------|-----------|--|

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

PFSWEB, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31
(In thousands)

| | 2005 | 2004 | 2003 |
|--|-------------|----------------|--------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ (747) | \$ 226 | \$ (3,746) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Depreciation and amortization | 6,112 | 4,643 | 4,497 |
| Loss on disposition of assets | | | 32 |
| Asset and lease impairments | | | 257 |
| Provision for doubtful accounts | 25 | 289 | 351 |
| Provision for excess and obsolete inventory | | 1,204 | 1,984 |
| Deferred income taxes | (8) | (81) | (134) |
| Non-cash compensation expense | 16 | 14 | 6 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivables | (4,490) | (9,838) | 173 |
| Inventories, net | (825) | (318) | 2,527 |
| Prepaid expenses, other receivables and other assets | (1,837) | (5,825) | 896 |
| Accounts payable, accrued expenses and other liabilities | 2,510 | 15,149 | (5,565) |
| Net cash provided by operating activities | 756 | 5,463 | 1,278 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchases of property and equipment | (3,918) | (7,698) | (1,982) |
| Decrease (increase) in restricted cash | 1,143 | (1,071) | 1,744 |
| Net cash used in investing activities | (2,775) | (8,769) | (238) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Net proceeds from issuance of common stock | 2,076 | 475 | 4,059 |
| Decrease (increase) in restricted cash | 50 | (359) | 268 |
| Payments on capital lease obligations | (1,199) | (1,134) | (954) |
| Proceeds from debt, net | 1,188 | 3,266 | 1,816 |
| Net cash provided by financing activities | 2,115 | 2,248 | 5,189 |
| EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS | | | |
| | (5) | (93) | (81) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 91 | (1,151) | 6,148 |

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| | | | |
|--|-----------|-----------|-----------|
| CASH AND CASH EQUIVALENTS, beginning of period | 13,592 | 14,743 | 8,595 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 13,683 | \$ 13,592 | \$ 14,743 |
| SUPPLEMENTAL CASH FLOW INFORMATION | | | |
| Non-cash investing and financing activities: | | | |
| Property and equipment acquired under capital leases | \$ 1,125 | \$ 1,330 | \$ 538 |

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

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PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Overview

PFSweb, Inc. Overview

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

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

Supplies Distributors Overview

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

Supplies Distributors has obtained certain financing (see Notes 3 and 4) that allows it to fund the working capital requirements for the sale of primarily IBM products. Pursuant to the transaction management services agreements, PFSweb provides to Supplies Distributors such services as managed web hosting and maintenance, procurement support, web-enabled customer contact center services, customer relationship management, financial services including billing and collection services, information management, and international distribution services. Additionally, IBM and Supplies Distributors have outsourced the product demand generation to a third party. Supplies Distributors sells its products in the United States, Canada and Europe.

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

2. Significant Accounting Policies

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Investment in Affiliate

PFSweb has loaned Supplies Distributors monies in the form of a Subordinated Demand Note (the Subordinated Note). Under the terms of certain of the Company's debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than \$8.0 million or decreased to lower than \$6.5 million without prior approval of the Company's lenders (see Notes 3 and 4). As of December 31, 2005 and 2004, the outstanding balance of the Subordinated Note, which is eliminated upon the consolidation of Supplies Distributors' financial position, was \$7.0 million in each year.

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Use of Estimates

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

Revenue and Cost Recognition

Depending on the terms of the customer arrangement, the Company recognizes product revenue and product cost either upon the shipment of product to customers or when the customer receives the product. The Company permits its customers to return product for credit against other purchases, which include returns for defective products (that the Company then returns to the manufacturer) and incorrect shipments. The Company provides a reserve for estimated returns and allowances. The Company offers terms to its customers that it believes are standard for its industry.

Freight costs billed to customers are reflected as components of product revenues. Freight costs incurred by Supplies Distributors are recorded as a component of cost of goods sold.

Under the master distributor agreements (see Note 6), the Company bills IBM for reimbursements of certain expenses, including: pass through customer marketing programs, including rebates and coop funds; certain freight costs; direct costs incurred in passing on any price decreases offered by IBM to Supplies Distributors or its customers to cover price protection and certain special bids; the cost of products provided to replace defective product returned by customers; and certain other expenses as defined. The Company records a receivable for these reimbursable amounts as they are incurred with a corresponding reduction in either inventory or cost of product revenue. The Company also reflects pass through customer marketing programs as a reduction of product revenue.

The Company's service fee revenues primarily relate to its (1) distribution services, (2) order management/customer care services and (3) the reimbursement of out-of-pocket and third-party expenses. The Company typically charges its service fee revenue on a cost-plus basis, a percent of shipped revenue basis or a per transaction basis, such as a per item basis for fulfillment services or a per minute basis for web-enabled customer contact center services. Additional fees are billed for other services.

Distribution services relate primarily to inventory management, product receiving, warehousing and fulfillment (i.e., picking, packing and shipping) and facilities and operations management. Service fee revenue for these activities is recognized as earned, which is either (i) on a per transaction basis or (ii) at the time of product fulfillment, which occurs at the completion of the distribution services.

Order management/customer care services relate primarily to taking customer orders for the Company's clients products via various channels such as telephone call-center, electronic or facsimile. These services also entail addressing customer questions related to orders, as well as cross-selling/up-selling activities. Service fee revenue for this activity is recognized as the services are rendered. Fees charged to the client are on a per transaction basis based on either (i) a pre-determined fee per order or fee per telephone minutes incurred, (ii) a per dedicated agent fee, or (iii) are included in the product fulfillment service fees that are recognized on product shipment.

The Company's billings for reimbursement of out-of-pocket expenses, including travel and certain third-party vendor expenses such as shipping and handling costs and telecommunication charges are included in pass-through revenue. The related reimbursable costs are reflected as cost of pass-through revenue.

The Company's cost of service fee revenue, representing the cost to provide the services described above, is recognized as incurred. Cost of service fee revenue also includes certain costs associated with technology collaboration and ongoing technology support that include maintenance, web hosting and other ongoing programming activities. These activities are primarily performed to support the distribution and order

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

management/customer care services and are recognized as incurred.

The Company recognizes revenue and records trade accounts receivables, pursuant to the methods described above, when collectibility is reasonably assured. Collectibility is evaluated in the aggregate and on an individual customer basis taking into consideration payment due date, historical payment trends, current financial position, results of independent credit evaluations and payment terms.

The Company primarily performs its services under one to three-year contracts that can generally be terminated by either party. In conjunction with these long-term contracts, the Company sometimes receives start-up fees to cover its implementation costs, including certain technology infrastructure and development costs. The Company defers the fees received, and the related costs, and amortizes them over the life of the contract. The amortization of deferred revenue is included as a component of service fee revenue. The amortization of deferred implementation costs is included as a cost of service fee revenue. To the extent implementation costs for non-technology infrastructure and development exceed the fees received, the excess costs are expensed as incurred. The following summarizes the deferred implementation revenues and costs, excluding technology and development costs, which are included in property and equipment (in thousands):

| | December 31, 2005 | December 31, 2004 |
|----------------------------------|-------------------------|-------------------------|
| Deferred implementation revenues | | |
| Current | \$ 1,547 | \$ 898 |
| Non-current | 862 | 821 |
| | \$ 2,409 | \$ 1,719 |
| Deferred implementation costs | | |
| Current | \$ 950 | \$ 507 |
| Non-current | 579 | 658 |
| | \$ 1,529 | \$ 1,165 |

Current and non-current deferred implementation costs, excluding technology and development costs, are a component of prepaid expenses and other assets, respectively. Current and non-current deferred implementation revenues, which may precede the timing of when the related implementation costs are incurred and thus deferred, are a component of accrued expenses and other liabilities, respectively.

Concentration of Business and Credit Risk

The Company's product revenue is primarily generated by sales to customers of product purchased under master distributor agreements with one supplier. The Company's service fee revenue is generated under contractual service fee relationships with multiple client relationships. A summary of the customer and client concentrations is as follows:

| | December 31, 2005 | December 31, 2004 | December 31, 2003 |
|---|-------------------------|-------------------------|-------------------------|
| Product Revenue (as a percentage of Product Revenue): | | | |
| Customer 1 | 14% | 9% | 12% |
| Customer 2 | 12% | 12% | 13% |
| Customer 3 | 11% | 11% | 10% |

Service Fee Revenue (as a percentage of Service Fee Revenue):

| | | | |
|----------|-----|-----|-----|
| Client 1 | 27% | 42% | 40% |
| Client 2 | 12% | 15% | 16% |
| Client 3 | 16% | | |

Consolidated Revenue:

| | | | |
|----------------------|-----|-----|-----|
| Customer/Client 1 | 10% | 7% | 10% |
| Customer/Client 2 | 7% | 18% | 16% |
| Accounts Receivable: | | | |
| 2 Customers/Clients | 22% | 27% | 37% |

In conjunction with Supplies Distributors' financings, PFSweb has provided certain collateralized guarantees on behalf of Supplies Distributors. Supplies Distributors' ability to obtain financing on similar terms would be significantly impacted without these guarantees. Additionally, since Supplies Distributors has limited personnel and physical resources, its ability to conduct business could be materially impacted by contract terminations by the third party performing product demand generation for the IBM products.

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

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash includes the following items (in thousands):

| | December 31, 2005 | December 31, 2004 |
|----------------------------|----------------------------------|----------------------------------|
| Current: | | |
| Letters of credit security | \$ 525 | \$ 225 |
| Customer remittances | 1,139 | 1,190 |
| Bond financing | 413 | 1,331 |
| Total current | 2,077 | 2,746 |
| Long term: | | |
| Letters of credit security | 150 | 675 |
| Total restricted cash | \$ 2,227 | \$ 3,421 |

The Company has cash restricted as collateral for letters of credit that secure certain debt and lease obligations (see Notes 4 and 9). The letters of credit currently expire at various dates through March 2007.

In conjunction with certain of its financing agreements, Supplies Distributors has granted to its lenders a security interest in certain customer remittances received in specified bank accounts (see Note 4). At December 31, 2005 and 2004, these bank accounts held \$1.1 million and \$1.2 million, respectively, which was restricted for payment to the lenders against the outstanding debt.

Other Receivables and Liabilities

Other receivables include \$9.8 million and \$7.9 million as of December 31, 2005 and 2004, respectively, for amounts due from IBM for billings under the master distributor agreements (see Note 6).

During 2001, the Company received a governmental grant for investments made in fixed assets in its Belgium operations. At establishment, the total grant of approximately \$1.6 million was deferred and is being recognized as a reduction in depreciation expense during the same period during which the related fixed assets are being depreciated. As of December 31, 2005 and 2004, the current portion of the unamortized grant, which was \$0.2 million and \$0.3 million, respectively, is included in accrued expenses and the long-term portion of the unamortized grant, which was \$0.2 million and \$0.5 million, respectively, is included in other liabilities in the accompanying consolidated balance sheets. For the years ended December 31, 2005, 2004 and 2003, the Company recognized approximately \$0.3 million as a reduction of depreciation expense related to the grant.

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Inventories

Inventories (all of which are finished goods) are stated at the lower of weighted average cost or market. Supplies Distributors assumes responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined (see Note 6). The Company reviews inventory for impairment on a periodic basis, but at a minimum, annually. Recoverability of the inventory on hand is measured by comparison of the carrying value of the inventory to the fair value of the inventory. During 2003, the Company agreed to certain modifications to a selected master distributor agreement. As a result of these modifications, the Company reevaluated its inventory for impairment during 2003, and increased its allowance for slow moving inventory. As of December 31, 2005 and 2004, the allowance for slow moving inventory was \$1.5 million and \$2.5 million, respectively.

In the event PFSweb, Supplies Distributors and IBM terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors' then existing inventory.

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

Property and Equipment

The components of property and equipment as of December 31, 2005 and 2004 are as follows (in thousands):

| | December 31, 2005 | December 31, 2004 | Depreciable Life |
|--|----------------------------------|----------------------------------|-----------------------------|
| Furniture and fixtures | \$ 17,399 | \$ 9,996 | 2-10 years |
| Purchased and capitalized software costs | 10,473 | 9,356 | 1-7 years |
| Computer equipment | 8,611 | 8,130 | 2-3 years |
| Leasehold improvements | 5,879 | 6,044 | 2-9 years |
| Other, primarily construction-in-progress | 150 | 3,982 | 3-7 years |
| | 42,512 | 37,508 | |
| Less-accumulated depreciation and amortization | (29,472) | (23,244) | |
| Property and equipment, net | \$ 13,040 | \$ 14,264 | |

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized over the shorter of the useful life of the related asset or the remaining lease term.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value would be determined using appraisals, discounted cash flow analysis or similar valuation techniques. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company's property held under capital leases amount to approximately \$3.3 million and \$3.0 million, net of accumulated amortization of approximately \$8.3 million and \$5.4 million, at December 31, 2005 and 2004, respectively.

Foreign Currency Translation and Transactions

For the Company's Canadian and European operations, the local currency is the functional currency. All assets

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

and liabilities are translated at exchange rates in effect at the end of the period, and income and expense items are translated at the average exchange rates for the period.

The Company includes currency gains and losses on short-term intercompany advances in the determination of net income. Currency gains and losses, including transaction gains and losses and those on short-term intercompany advances, included in net income or loss were a net loss of approximately \$0.3 million and net gains of \$0.2 million and \$0.3 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company will continue to report gains or losses on intercompany foreign currency transactions that are of a long-term investment nature as a separate component of shareholders' equity.

Stock-Based Compensation

The Company accounts for stock-based employee compensation plans using the intrinsic-value method as outlined under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and related interpretations. The following table shows the pro forma effect on the Company's net income (loss) and income (loss) per share as if compensation cost had been recognized for stock-based employee compensation plans based on their fair value at the date of the grant. The pro forma effect of stock-based employee compensation plans on the Company's net income (loss) for those years may not be representative of the pro forma effect for future years due to the impact of vesting and potential future awards.

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|---|---|---|---|
| | (In thousands, except per share amounts) | | |
| Net income (loss) as reported | \$ (747) | \$ 226 | \$ (3,746) |
| Add: Stock-based non-employee compensation expense included in reported net loss | 2 | 14 | 6 |
| Deduct: total stock-based employee and non-employee compensation expense determined under fair value based method | (1,002) | (841) | (754) |
| Pro forma net loss, applicable to common stock for basic and diluted computations | \$ (1,747) | \$ (601) | \$ (4,494) |
| Income (loss) per common share as reported | | | |
| Basic and diluted | \$ (0.03) | \$ 0.01 | \$ (0.20) |
| Loss per common share pro forma | | | |
| Basic and diluted | \$ (0.08) | \$ (0.03) | \$ (0.24) |

Impact of Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share-Based Payment* (SFAS 123R), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, (SFAS 123) and supersedes APB Opinion No. 25. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, *Share-Based Payment*, which provides interpretive guidance related to SFAS 123R. SFAS 123R requires all share-based payment transactions to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement

recognition. The Company will adopt SFAS 123R effective January 1, 2006 using the modified prospective transition method of adoption and expects the adoption to result in approximately \$0.8 million of compensation expense in 2006, without considering future grants.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount more likely than

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

not to be realized.

Self Insurance

The Company is self-insured for medical insurance benefits up to certain stop-loss limits. Such costs are accrued based on known claims and an estimate of incurred, but not reported (IBNR) claims. IBNR claims are estimated using historical lag information and other data provided by claims administrators.

Fair Value of Financial Instruments

The carrying value of the Company's financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable and debt and capital lease obligations, approximate their fair values based on short terms to maturity or current market prices and interest rates.

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income (loss) consists of net income (loss) and foreign currency translation adjustments.

Net Income (Loss) Per Common Share

Basic and diluted net income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted-average number of common shares outstanding for the reporting period. For the calculation of diluted net income per share for the year ended 2004, weighted average shares outstanding are increased by approximately 2.1 million shares, reflecting the dilutive effect of stock options. Stock options not included in the calculation of diluted net income (loss) per share for the years ended December 31, 2005, 2004 and 2003, were 5.4 million, 0.7 million, and 4.4 million, respectively, as the effect would be anti-dilutive. Warrants not included in the calculation of diluted net income (loss) per share for the years ended December 31, 2005 and 2004, were 0.4 million and 0.9 million, respectively, as the effect would be anti-dilutive.

Cash Paid During Year

The Company made payments for interest of approximately \$1.9 million, \$1.7 million and \$1.9 million and income taxes of approximately \$0.7 million, \$0.6 million and \$0.5 million during the years ended December 31, 2005, 2004, and 2003, respectively (see Notes 3, 4 and 8).

3. Vendor Financing

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

| | December 31, 2005 | December 31, 2004 |
|---|----------------------------------|----------------------------------|
| Inventory and working capital financing agreements: | | |
| United States | \$ 30,092 | \$ 26,962 |
| Europe | 12,071 | 13,110 |
| Total | \$ 42,163 | \$ 40,072 |

Inventory and Working Capital Financing Agreement, United States

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of IBM products in the United States, providing financing for eligible IBM inventory and for certain other receivables up to \$30.5 million through its expiration in March 2006. As of December 31, 2005, Supplies Distributors had \$0.4 million of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including its parent company subsidiaries and PFSweb), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$7.0 million and a minimum shareholders' equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 1% (8.25% and 6% as of December 31, 2005 and 2004, respectively). The facility also includes a monthly service fee.

On March 28, 2006, Supplies Distributors entered into an amended credit facility with IBM Credit LLC, which extends the termination date through March 2007, reduces the minimum Subordinated Note balance to \$6.5 million, and reduces the interest rate to prime plus 0.5%. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors' European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. (IBM Belgium) to finance their distribution of IBM products in Europe. The asset based credit facility with IBM Belgium provides up to 12.5 million Euros (approximately \$14.8 million) in financing for purchasing IBM inventory and for certain other receivables through its expiration in March 2006. As of December 31, 2005, Supplies Distributors' European subsidiaries had 2.3 million euros (\$2.7 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiaries to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including its parent company, sister company and PFSweb), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors' European subsidiaries, as well as collateralized guaranties of Supplies Distributors and PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$7.0 million and a minimum shareholders' equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at Euribor plus 2.0% and 2.5% as of December 31, 2005 and 2004, respectively (4.1% and 4.7% as of December 31, 2005 and 2004, respectively). Supplies Distributors' European subsidiaries pay a monthly service fee on the commitment. In addition, a security interest was granted to IBM Belgium for certain European customer remittances received in specified bank accounts.

On March 28, 2006, Supplies Distributors' European subsidiaries entered into an amended credit facility with IBM Belgium, which extends the termination date through March 2007, reduces the minimum Subordinated Note balance to \$6.5 million and reduces the interest rate to Euribor plus 1.5%. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

4. Debt and Capital Lease Obligations:

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

| | December 31, 2005 | December 31, 2004 |
|---|----------------------------------|----------------------------------|
| Loan and security agreements, United States: | | |
| Supplies Distributors | \$ 11,673 | \$ 8,328 |
| PFSweb | 6,640 | 4,853 |
| Factoring agreement, Europe | 576 | 3,848 |
| Taxable revenue bonds | 5,000 | 5,000 |
| Master lease agreements | 3,713 | 3,141 |
| Inventory and working capital financing agreement | | |
| Europe | | 682 |

| | | |
|--|----------|----------|
| Other | 313 | 478 |
| Total | 27,915 | 26,330 |
| Less current portion of long-term debt | 21,626 | 19,098 |
| Long-term debt, less current portion | \$ 6,289 | \$ 7,232 |

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)*****Loan and Security Agreement Supplies Distributors***

Supplies Distributors has a loan and security agreement with Congress Financial Corporation (Southwest) (Congress) to provide financing for up to \$25 million of eligible accounts receivable in the United States and Canada. As of December 31, 2005, Supplies Distributors had \$4.6 million of available credit under this agreement. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement (see Note 6) no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement. Borrowings under the Congress facility accrue interest at prime rate to prime rate plus 0.25% or Eurodollar rate plus 2.25% to 2.75%, dependent on excess availability, as defined. The interest rate as of December 31, 2005 was 7.25% for \$7.7 million of outstanding borrowings and 6.6% for \$4.0 million of outstanding borrowings. This agreement contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including its parent company, subsidiaries and PFSweb), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than \$6.5 million and restricted cash of less than \$5.0 million, and is restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Congress pursuant to which a security interest was granted to Congress for all U.S. and Canadian customer remittances received in specified bank accounts. At December 31, 2005 and December 31, 2004, these bank accounts held \$1.0 million and \$1.2 million, respectively, which was restricted for payment to Congress.

Loan and Security Agreement PFSweb

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to \$7.5 million of eligible accounts receivable financing (Working Capital Advances) through March 2007 and \$2.5 million of equipment financing (Equipment Advances) through June 15, 2008. Outstanding Working Capital Advances, \$5.4 million as of December 31, 2005, accrue interest at prime rate plus 1% (8.25% as of December 31, 2005). Outstanding Equipment Advances, \$1.2 million as of December 31, 2005, accrue interest at prime rate plus 1.5% (8.75% as of December 31, 2005). As of December 31, 2005, PFS had \$1.7 million of available credit under the Working Capital Advance portion of this facility and no funds available under the Equipment Advance portion of this facility. In January 2006, the Company repaid the \$5.4 million of Working Capital Advances outstanding as of December 31, 2005. The Comerica Agreement contains cross default provisions, various restrictions upon ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including its subsidiaries and sister companies), make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of \$20 million, as defined, a minimum earnings before interest and taxes, plus depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the Subordinated Note to a maximum of \$8 million. As of March 31, 2006, Comerica has provided approval for PFS to use \$3.5 million in cash to fund the cash flow requirements of eCOST.com (see Note 13), a portion of which is subject to certain restrictions. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb, Inc. The Comerica Agreement requires PFS to maintain a minimum cash balance of \$1.3 million at Comerica.

Factoring Agreement

Supplies Distributors European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (Fortis) to provide factoring for up to 7.5 million euros (approximately \$8.9 million) of eligible accounts receivables through March 2007. As of December 31, 2005, Supplies Distributors European subsidiary had approximately 3.2 million euros (\$3.8 million) of available credit under this agreement. Borrowings accrue interest at Euribor plus 0.6% (3.0% at

December 31, 2005). This agreement contains various restrictions upon the ability of Supplies Distributors European subsidiary to, among other things, merge, consolidate and incur indebtedness, as well as financial covenants, such as minimum net worth. This agreement is secured by a guarantee of Supplies

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Distributors, up to a maximum of 200,000 euros.

Taxable Revenue Bonds

PFSweb has a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) in connection with the issuance by the MBFC of \$5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned the proceeds of the Bonds to PFSweb for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in the Company's Southaven, Mississippi distribution facility. The Bonds bear interest at a variable rate (4.35% as of December 31, 2005), as determined by Comerica Securities, as Remarketing Agent. PFSweb, at its option, may convert the Bonds to a fixed rate, to be determined by the Remarketing Agent at the time of conversion.

The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) in the initial face amount of \$5.1 million issued by Comerica pursuant to a Reimbursement Agreement between PFSweb and Comerica under which PFSweb is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of January 2007 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. If the Letter of Credit is renewed or replaced, the Bonds require future principal repayments at \$500,000 in January 2007 and \$800,000 in cash of January 2008 through 2012. PFSweb has established a sinking fund account with Comerica, which at December 31, 2005 includes \$0.4 million restricted for payments on the Bonds.

Debt Covenants

To the extent the Company fails to comply with its covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of stockholders' equity (\$20.0 million), and one or all of the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company's financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

PFSweb has also provided a guarantee of the obligations of Supplies Distributors to IBM, excluding the trade payables that are financed by IBM credit.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit Corporation (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of 3 to 5 years. The outstanding leasing transactions (\$0.7 million and \$1.2 million as of December 31, 2005 and 2004, respectively) are secured by the related equipment and letters of credit (see Note 2). The outstanding financing transactions (\$0.2 million and \$0.5 million as of December 31, 2005 and 2004, respectively) are secured by a letter of credit (see Note 2).

The Company has a master agreement with a leasing company that provided for leasing transactions of certain equipment. The amounts outstanding under this agreement as of December 31, 2005 and 2004 were \$1.9 million and \$1.2 million, respectively, and are secured by the related equipment.

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

Debt and Capital Lease Maturities

The Company's aggregate maturities of debt subsequent to December 31, 2005 are as follows (in thousands):

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

| | |
|--------------------------------|---------------|
| Fiscal year ended December 31, | |
| 2006 | \$ 19,403 |
| 2007 | 900 |
| 2008 | 800 |
| 2009 | 800 |
| 2010 | 800 |
| Thereafter | 1,600 |
| Total | \$ 24,303 |

The following is a schedule of the Company's future minimum lease payments under the capital leases together with the present value of the net minimum lease payments as of December 31, 2005 (in thousands):

| | |
|---|--------------|
| Fiscal year ended December 31, | |
| 2006 | \$ 2,443 |
| 2007 | 938 |
| 2008 | 384 |
| 2009 | 132 |
| Thereafter | 55 |
| Total minimum lease payments | \$ 3,952 |
| Less amount representing interest at rates ranging from 5.5% to 15.4% | (340) |
| Present value of net minimum lease payments | 3,612 |
| Less: Current portion | (2,223) |
| Long-term capital lease obligations | \$ 1,389 |

5. Stock and Stock Options

Preferred Stock Purchase Rights

On June 8, 2000, the Company's Board of Directors declared a dividend distribution of one preferred stock purchase right (a "Right") for each share of the Company's common stock outstanding on July 6, 2000 and each share of common stock issued thereafter. Each Right entitles the registered shareholders to purchase from the Company one one-thousandth of a share of preferred stock at an exercise price of \$67, subject to adjustment. The Rights are not currently exercisable, but would become exercisable if certain events occurred relating to a person or group acquiring or attempting to acquire 15 percent or more of the Company's outstanding shares of common stock. The Rights expire on July 6, 2010, unless redeemed or exchanged by the Company earlier.

Employee Stock Purchase Plan

In 2000, the Company's shareholders approved the PFSweb Employee Stock Purchase Plan (the "Stock Purchase Plan") that is qualified under Section 423 of the Internal Revenue Code of 1986, to provide employees of the Company an opportunity to acquire a proprietary interest in the Company. The Stock Purchase Plan provided for acquisition of the Company's common stock at a 15% discount to the lower of the beginning or end of a calendar quarter's market value. The Stock Purchase Plan permits each U.S. employee who has completed ninety days of service to elect to participate in the plan. Eligible employees may elect to contribute with after-tax dollars up to a maximum annual contribution of \$25,000. In 2005, the Company's shareholders approved amendments to the Stock Purchase Plan that increased the number of shares of common stock reserved for issuance under the Stock Purchase Plan and effective

January 1, 2006 reduced the acquisition price discount to 5% of the market value on the date of purchase. The Company has reserved 4.0 million shares of its common stock under the Stock Purchase Plan. During the years ended December 31, 2005, 2004 and 2003, the Company issued 401,270, 226,381 and 618,446 shares under the Stock Purchase Plan, respectively. As of December 31, 2005, there were 2,225,920 shares available for further issuance under the Stock Purchase Plan, of which 14,691 were issued in January 2006.

Private Placement Transaction

In November 2003, the Company entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which the Company issued and sold an aggregate of

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

1,581,944 shares of its common stock, par value \$.001 per share (the Common Stock), at \$2.16 per share, resulting in gross proceeds of \$3.4 million. After deducting expenses, the net proceeds were approximately \$3.2 million. In addition to the Common Stock, the investors received one-year warrants to purchase an aggregate 525,692 shares of Common Stock at an exercise price of \$3.25 per share and four-year warrants to purchase an aggregate of 395,486 shares of Common Stock at an exercise price of \$3.30 per share. In January 2005, 394,685 of the one-year warrants were exercised prior to their expiration, generating net proceeds to the Company of \$1.3 million, and 131,277 of the one-year warrants expired unexercised. As a result of the merger with eCOST (see Note 13), the four-year warrants have been adjusted such that there are now 528,382 warrants outstanding with an exercise price of \$2.47 per share.

Stock Options and Stock Option Plans*PFSweb Plan Options*

The Company has authorized 8,500,000 shares of common stock for issuance under two 1999 stock option plans and 35,000 shares for issuance under a stock option agreement (the Stock Option Plans). The Stock Option Plans provide for the granting of incentive awards in the form of stock options to directors, executive management, key employees, and outside consultants of the Company. The right to purchase shares under the employee stock option agreements typically vest over a three-year period, one-twelfth each quarter. Stock options must be exercised within 10 years from the date of grant. Stock options are generally issued at fair market value. The Company recorded stock based compensation expense of \$16,000, \$14,000 and \$6,000 in the years ended December 31, 2005, 2004 and 2003, respectively, in connection with stock options to purchase an aggregate of 31,000 shares issued under the Stock Option Plans to non-employees.

As of December 31, 2005, there were 2,942,447 shares available for future options under the Stock Option Plans.

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

| | | Price Per | | Weighted |
|--------------------------------|-----------|-----------|---------|----------------|
| | Shares | Share | | Average |
| | | | | Exercise Price |
| Outstanding, December 31, 2002 | 3,605,669 | \$ 0.44 | \$16.00 | \$ 1.12 |
| Granted | 835,000 | \$0.39 | \$2.26 | \$ 0.42 |
| Exercised | (328,730) | \$0.39 | \$1.92 | \$ 0.81 |
| Canceled | (256,208) | \$0.39 | \$1.92 | \$ 1.10 |
| Outstanding, December 31, 2003 | 3,855,731 | \$0.39 | \$16.00 | \$ 1.00 |
| Granted | 808,000 | \$1.48 | \$2.96 | \$ 1.64 |
| Exercised | (160,133) | \$0.39 | \$1.92 | \$ 0.85 |
| Canceled | (61,491) | \$0.39 | \$10.45 | \$ 1.65 |
| Outstanding, December 31, 2004 | 4,442,107 | \$0.39 | \$16.00 | \$ 1.11 |
| Granted | 767,000 | \$1.76 | \$2.57 | \$ 2.51 |
| Exercised | (120,740) | \$0.39 | \$1.92 | \$ 1.21 |
| Canceled | (140,417) | \$0.39 | \$2.57 | \$ 1.96 |
| Outstanding, December 31, 2005 | 4,947,950 | \$0.39 | \$16.00 | \$ 1.30 |

As of December 31, 2005 and 2004, 4,033,136 and 3,395,120 options were exercisable, respectively. The weighted average fair value per share of options granted during the years ended December 31, 2005, 2004 and 2003 was \$2.07, \$1.40 and \$0.35, respectively.

The following table summarizes information concerning currently outstanding and exercisable stock options issued under the Stock Option Plans as of December 31, 2005:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--------------------------|-------------------------------------|---|---------------------------------|-------------------------------------|---------------------------------|
| | Outstanding as of December 31, 2005 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Exercisable as of December 31, 2005 | Weighted Average Exercise Price |
| \$0.39-\$0.91 | 2,912,845 | 6.3 | \$ 0.78 | 2,799,052 | \$ 0.79 |
| \$1.16-\$1.92 | 1,340,355 | 6.7 | \$ 1.74 | 1,022,584 | \$ 1.77 |
| \$2.05-\$2.96 | 687,000 | 9.0 | \$ 2.58 | 203,750 | \$ 2.59 |
| \$10.45-\$16.00 | 7,750 | 3.6 | \$11.17 | 7,750 | \$11.17 |
| | 4,947,950 | 6.8 | \$ 1.30 | 4,033,136 | \$ 1.15 |

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

PFSweb Non-plan Options

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

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

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

As of December 31, 2005, 439,235 Non-plan Options were outstanding, all of which were held by PFSweb officers, directors and employees.

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

| | Shares | Price Per Share | | Weighted Average Exercise Price | |
|--------------------------------|---------------|------------------------|----------|--|------|
| Outstanding, December 31, 2002 | 1,184,807 | \$ 0.91 | \$10.58 | \$ | 1.05 |
| Granted | | \$ | | \$ | |
| Exercised | (320,838) | \$ 0.91 | \$1.17 | \$ | 1.10 |
| Canceled | (359,001) | \$ 0.91 | \$1.17 | \$ | 1.16 |
| Outstanding, December 31, 2003 | 504,968 | \$ 0.91 | \$10.58 | \$ | 0.95 |
| Granted | | \$ | | \$ | |
| Exercised | (31,130) | \$ 0.91 | | \$ | 0.91 |
| Canceled | (569) | \$ 5.78 | \$ 10.58 | \$ | 6.47 |
| Outstanding, December 31, 2004 | 473,269 | \$ 0.91 | \$10.58 | \$ | 0.95 |
| Granted | | \$ | | \$ | |
| Exercised | (31,034) | \$ 0.91 | | \$ | 0.91 |
| Canceled | (3,000) | \$ 0.91 | | \$ | 0.91 |
| Outstanding, December 31, 2005 | 439,235 | \$ 0.91 | \$10.58 | \$ | 0.95 |

As of December 31, 2005 and 2004, 439,235 and 473,269 of Non-plan Options outstanding were exercisable, respectively.

The following table summarizes information concerning Non-plan Options outstanding and exercisable as of December 31, 2005:

| Options Outstanding | Options Exercisable | |
|-----------------------------|----------------------------|-----------------|
| Weighted Average | Weighted | Weighted |

| Range of | Outstanding as of December 31, | Remaining Contractual Life | Average Exercise Price | Exercisable as of December 31, | Average Exercise Price |
|------------------------|---|---|---------------------------------------|---|---------------------------------------|
| Exercise Prices | 2005 | | | 2005 | |
| \$ 0.91 | 437,005 | 5.9 | \$0.91 | 437,005 | \$0.91 |
| \$ 5.78-\$10.58 | 2,230 | 2.0 | \$8.83 | 2,230 | \$8.83 |
| | 439,235 | 5.9 | \$0.95 | 439,235 | \$0.95 |

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Fair Value

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

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|----------------------------------|---|---|---|
| Expected dividend yield | | | |
| Expected stock price volatility | 104% - 105% | 107% - 118% | 115% - 118% |
| Risk-free interest rate | 3.6% - 4.6% | 3.9% - 4.8% | 3.4% - 4.3% |
| Expected life of options (years) | 5-6 | 5 | 5 |

The fair value of each share of common stock granted under the Stock Purchase Plan is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|-----------------------------------|---|---|---|
| Expected dividend yield | | | |
| Expected stock price volatility | 102% - 107% | 107% - 115% | 115% - 119% |
| Risk-free interest rate | 2.3% - 4.0% | 0.9% - 2.2% | 0.9% - 1.2% |
| Expected life of options (months) | 3 | 3 | 3 |

The weighted average fair value per share of common stock granted under the Stock Purchase Plan granted during the years ended December 31, 2005, 2004 and 2003 was \$0.98, \$0.74 and \$0.51, respectively.

6. Master Distributor Agreements

Supplies Distributors, PFSweb and IBM have entered into master distributor agreements whereby Supplies Distributors acts as a master distributor of various IBM products and PFSweb provides transaction management and fulfillment services to Supplies Distributors. The master distributor agreements expire in March 2007 and can be extended for additional one-year terms upon mutual agreement by all parties. Under the master distributor agreements, IBM sells product to Supplies Distributors and reimburses Supplies Distributors for certain freight costs, direct costs incurred in passing on any price decreases offered by IBM to Supplies Distributors or its customers to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and other certain expenses as defined. Supplies Distributors can return to IBM product rendered obsolete by IBM engineering changes after customer demand ends. IBM determines when a product is obsolete. IBM and Supplies Distributors also have verbal agreements under which IBM reimburses or collects from Supplies Distributors amounts calculated in certain inventory cost adjustments.

Supplies Distributors passes through to customers marketing programs specified by IBM and administers, along with a party performing product demand generation for the IBM products, such programs according to IBM guidelines.

7. Supplies Distributors

Pursuant to an operating agreement, Supplies Distributors is restricted from making any distributions to PFSweb if, after giving effect thereto, Supplies Distributors net worth would be less than \$1.0 million. At December 31, 2005, Supplies Distributors net worth was \$8.8 million. Under the terms of its amended credit agreements, Supplies Distributors is currently restricted from paying annual cash dividends without the prior approval of its lenders (see Notes 3 and 4). In June 2005, Supplies Distributors paid a \$1.0 million dividend to PFSweb. In 2004, Supplies Distributors paid a \$0.8 million dividend to PFSweb. In September 2003, Supplies Distributors paid a \$0.6 million dividend to PFSweb.

8. Income Taxes

A reconciliation of the difference between the expected income tax expense at the U.S. federal statutory corporate tax rate of 34%, and the Company's effective tax rate is as follows (in thousands):

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PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|---|---|---|---|
| Income tax provision (benefit) computed at statutory rate | \$ 86 | \$ 326 | \$ (1,079) |
| Impact of foreign taxation | (16) | (9) | (48) |
| Items not deductible for tax purposes | 337 | 60 | 623 |
| Change in valuation reserve | 706 | 478 | 1,197 |
| Other | (112) | (121) | (121) |
| Provision for income taxes | \$ 1,001 | \$ 734 | \$ 572 |

The consolidated income (loss) before income taxes, by domestic and foreign entities, is as follows (in thousands):

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|----------|---|---|---|
| Domestic | \$ (1,211) | \$ (549) | \$ (2,745) |
| Foreign | 1,465 | 1,509 | (429) |
| Total | \$ 254 | \$ 960 | \$ (3,174) |

Current and deferred income tax expense (benefit) is summarized as follows (in thousands):

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|----------------|---|---|---|
| Current | | | |
| Domestic | \$ 151 | \$ 74 | \$ 79 |
| State | 80 | 49 | 64 |
| Foreign | 778 | 692 | 563 |
| Total current | 1,009 | 815 | 706 |
| Deferred | | | |
| Domestic | | | |
| State | | | (31) |
| Foreign | (8) | (81) | (103) |
| Total deferred | (8) | (81) | (134) |
| Total | \$ 1,001 | \$ 734 | \$ 572 |

The components of the deferred tax asset (liability) are as follows (in thousands):

| | December 31, 2005 | December 31, 2004 |
|----------------------------------|----------------------------------|----------------------------------|
| Deferred tax asset: | | |
| Allowance for doubtful accounts | \$ 164 | \$ 171 |
| Inventory reserve | 641 | 761 |
| Property and equipment | 1,140 | 74 |
| Net operating loss carryforwards | 10,129 | 10,812 |
| Other | 670 | 612 |
| | 12,744 | 12,430 |
| Less Valuation reserve | 12,422 | 12,225 |
| Total deferred tax asset | 322 | 205 |
| Deferred tax liability | (108) | (166) |
| Deferred tax asset, net | \$ 214 | \$ 39 |

Management believes that PFSweb has not established a sufficient history of earnings, on a stand-alone basis, to support the more likely than not realization of certain deferred tax assets in excess of existing taxable temporary differences. A valuation allowance has been provided for these net deferred income tax assets as of December 31, 2005 and 2004. At December 31, 2005, net operating loss carryforwards relate to taxable losses of PFSweb's Europe subsidiary totaling approximately \$10.3 million, PFSweb's Canada subsidiary totaling approximately \$3.6 million

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

and PFSweb's U.S. subsidiary totaling approximately \$15.7 million that expire at various dates through 2020. The U.S. net operating loss carryforward includes \$4.6 million relating to tax benefits of stock option exercises and, if utilized, will be recorded against additional paid-in-capital upon utilization rather than as an adjustment to income tax expense from continuing operations.

9. Commitments and Contingencies

The Company leases facilities, warehouse, office, transportation and other equipment under operating leases expiring in various years through December 31, 2012. In most cases, management expects that, in the normal course of business, leases will be renewed or replaced by other leases. The Company also subleases a certain Canadian facility under a sublease agreement through December 31, 2006 as well one of our distribution facilities in Memphis, TN through December 31, 2008. Minimum future annual rental payments and sublease receipts under non-cancelable operating leases having original terms in excess of one year are as follows (in thousands):

| | Operating Lease Payments | Sub-Lease Income |
|--------------------------------|---|-----------------------------|
| Fiscal year ended December 31, | | |
| 2006 | \$ 7,485 | \$ 711 |
| 2007 | 6,319 | 572 |
| 2008 | 3,940 | 572 |
| 2009 | 1,863 | |
| 2010 | 924 | |
| Thereafter | 781 | |
| Total | \$ 21,312 | \$ 1,855 |

During the years ended December 31, 2005 and 2003, the Company relocated certain of its operations and entered into sublease agreements on the former facilities, which resulted in a charge of \$0.4 million and \$0.3 million, respectively, which is included in selling, general and administrative expense.

Total rental expense under operating leases approximated \$7.3 million, \$5.4 million and \$6.1 million for the years ended December 31, 2005, 2004 and 2003, respectively. Certain landlord required deposits are secured by letters of credit (see Note 2).

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. The Company plans to dispute the notice. If the dispute is not resolved favorably, the Company could be assessed additional taxes for calendar years 2005 and 2004. The Company has not accrued for the additional taxes, which for 2005 and 2004 could be \$0.4 million to \$0.5 million each year, as the Company does not believe that it is probable that an additional assessment will be incurred.

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

In the ordinary course of business, one or more of the Company's clients may dispute Company invoices for services rendered or other charges. As of December 31, 2005, an aggregate of approximately \$1.1 million of client invoices were in dispute. The Company believes it will resolve these disputes in its favor and has not recorded any

reserve for such disputes.

10. Segment and Geographic Information

The Company is organized into two operating segments: PFSweb is an international provider of integrated

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

business process outsourcing solutions and operates as a service fee business; Supplies Distributors is a master distributor of primarily IBM products.

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|---|---|---|---|
| Revenues (in thousands): | | | |
| PFSweb | \$ 87,883 | \$ 62,621 | \$ 44,824 |
| Supplies Distributors | 252,902 | 267,470 | 249,230 |
| Eliminations | (9,128) | (8,426) | (7,618) |
| | \$ 331,657 | \$ 321,665 | \$ 286,436 |
| Income (loss) from operations (in thousands): | | | |
| PFSweb | \$ (5,292) | \$ (3,495) | \$ (6,317) |
| Supplies Distributors | 7,275 | 5,908 | 5,114 |
| Eliminations | | 7 | 29 |
| | \$ 1,983 | \$ 2,420 | \$ (1,174) |
| Depreciation and amortization (in thousands): | | | |
| PFSweb | \$ 6,112 | \$ 4,636 | \$ 4,469 |
| Supplies Distributors | | 14 | 58 |
| Eliminations | | (7) | (30) |
| | \$ 6,112 | \$ 4,643 | \$ 4,497 |
| Capital expenditures (in thousands): | | | |
| PFSweb | \$ 3,918 | \$ 7,698 | \$ 1,982 |
| Supplies Distributors | | | |
| Eliminations | | | |
| | \$ 3,918 | \$ 7,698 | \$ 1,982 |
| Assets (in thousands): | | December 31, 2005 | December 31, 2004 |
| PFSweb | | \$ 60,337 | \$ 56,610 |
| Supplies Distributors | | 87,542 | 88,548 |
| Eliminations | | (16,153) | (14,831) |
| | | \$ 131,726 | \$ 130,327 |

Geographic areas in which the Company operates include the United States, Europe (primarily Belgium), and Canada. The following is geographic information by area. Revenues are attributed based on the Company's domicile.

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Year Ended December 31, 2003 |
|----------------------------|---|---|---|
| Revenues (in thousands): | | | |
| United States | \$ 249,461 | \$ 225,300 | \$ 199,309 |
| Europe | 89,603 | 99,979 | 89,781 |
| Canada | 8,090 | 9,834 | 12,730 |
| Inter-segment eliminations | (15,497) | (13,448) | (15,384) |
| | \$ 331,657 | \$ 321,665 | \$ 286,436 |

| | December 31, 2005 | December 31, 2004 |
|-----------------------------------|----------------------------------|----------------------------------|
| Long-lived assets (in thousands): | | |
| United States | \$ 11,874 | \$ 12,288 |
| Europe | 2,280 | 3,641 |
| Canada | 76 | 138 |
| | \$ 14,230 | \$ 16,067 |

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****11. Employee Savings Plan**

The Company has a defined contribution employee savings plan under Section 401(k) of the Internal Revenue Code. Substantially all full-time and part-time U.S. employees are eligible to participate in the plan. The Company, at its discretion, may match employee contributions to the plan and also make an additional matching contribution in the form of profit sharing in recognition of the Company's performance. During the years ended December 31, 2005 and 2004, the Company matched 20% of employee contributions totaling approximately \$116,000 and \$60,000, respectively. During the year ended December 31, 2003 the Company matched 10% of employee contributions totaling approximately \$30,000.

12. Quarterly Results of Operations (Unaudited)

Unaudited quarterly results of operations for years ended December 31, 2005 and 2004 were as follows (amounts in thousands except per share data):

| | Year Ended December 31, 2005 | | | |
|---|-------------------------------------|----------------------------|----------------------------|----------------------------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. |
| Total revenues | \$81,865 | \$84,870 | \$81,492 | \$83,430 |
| Total cost of revenues | 74,555 | 76,849 | 72,708 | 75,041 |
| Gross profit | 7,310 | 8,021 | 8,784 | 8,389 |
| Selling, general and administrative expenses | 6,966 | 7,952 | 8,441 | 7,162 |
| Income from operations | 344 | 69 | 343 | 1,227 |
| Net income (loss) | (214) | (546) | (453) | 466 |
| Basic and diluted net income (loss) per share | (0.01) | (0.02) | (0.02) | 0.02 |

| | Year Ended December 31, 2004 | | | |
|---|-------------------------------------|----------------------------|----------------------------|----------------------------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. |
| Total revenues | \$77,485 | \$80,020 | \$77,017 | \$87,143 |
| Total cost of revenues | 71,490 | 72,119 | 69,630 | 78,915 |
| Gross profit | 5,995 | 7,901 | 7,387 | 8,228 |
| Selling, general and administrative expenses | 7,132 | 6,910 | 6,451 | 6,598 |
| Income (loss) from operations | (1,137) | 991 | 936 | 1,630 |
| Net income (loss) | (1,767) | 479 | 420 | 1,094 |
| Basic and diluted net income (loss) per share | (0.08) | 0.02 | 0.02 | 0.05 |

The seasonality of the Company's business is dependent upon the seasonality of its clients' business and their sale of products. Management believes that with the Company's current client mix and their clients' business volumes, the Company's service fee revenue business activity is expected to be at its lowest in the quarter ended March 31. The Company's product revenue business activity is expected to be at its highest in the quarter ended December 31.

13. Subsequent Event

On February 1, 2006, the Company, Red Dog Acquisition Corp., a newly-formed wholly-owned subsidiary of the Company (Merger Sub), and eCOST.com, Inc. (eCOST), a multi-category online discount retailer of new, close-out and refurbished brand-name merchandise for consumers and small business buyers, consummated the transactions contemplated by the Agreement and Plan of Merger dated as of November 29, 2005 (the Merger Agreement), pursuant to which, among other things, effective as of February 1, 2006, Merger Sub was merged (the Merger) with and into eCOST, with eCOST remaining as the surviving corporation and a wholly-owned subsidiary of the Company. As of February 1, 2006, each of the 18,858,132 issued and outstanding shares of common stock of eCOST have been converted into the right to receive one share of common stock of the Company. In conjunction with the merger, we issued 30,000 warrants to a former eCOST shareholder with an exercise price of \$2.00 per share.

The Company is in the process of identifying the intangible assets acquired through the merger process. Upon the completion of this identification, the Company will assign values to the assets acquired including the intangible

PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

assets and goodwill. Using the average of the PFSweb closing stock price for the three days prior to the merger of \$1.42, and the estimated transaction costs of \$1.4 million, the estimated purchase price is approximately \$28 million.

The Company has provided guarantees of certain obligations of eCOST to its bank and a vendor and the company may provide additional guarantees in the future. eCOST has historically incurred significant operating losses and used cash to fund its operations. Through the merger, the Company plans to increase revenues, improve gross margins and reduce costs for this eCOST business.

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

The Company may be required to invest cash to fund eCOST's operations, which they can not do without approval from its lenders. As of March 31, 2006, the Company has received lender approval to use \$3.5 million in cash to fund eCOST's cash flow requirements. The Company can provide no assurance that they will receive further approval from its lenders if additional financing needs are required by eCOST.

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

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) *The following documents are filed as part of this report:*

1. *Financial Statements*

PFSweb, Inc. and Subsidiaries

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Operations

Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss)

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

Financial Statement Schedules

Schedule I Condensed Financial Information of Registrant

Schedule II Valuation and Qualifying Accounts

All other schedules are omitted because the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the financial statements or notes thereto.

2. *Exhibits*

| Exhibit Number | Description of Exhibits |
|-----------------------|--|
| 2.1 (19) | Agreement and Plan of Merger, dated as of November 29, 2005, by and among PFSweb, Inc., Red Dog Acquisition Corp and eCOST.com, Inc. |
| 3.1 (1) | Amended and Restated Certificate of Incorporation of PFSweb, Inc. |
| 3.1.1 (21) | Certificate of Amendment to Amended and Restated Certificate of Incorporation of PFSweb, Inc. |
| 3.2 (1) | Amended and Restated Bylaws of PFSweb, Inc. |
| 10.1 (17) | PFSweb, Inc. 2005 Employee Stock and Incentive Plan |
| 10.2 (17) | PFSweb, Inc. 2005 Employee Stock Purchase Plan. |
| 10.3 (18) | Amendment 3 to Loan and Security Agreement. |
| 10.4 (18) | Amendment 6 to Agreement for Inventory Financing. |

10.5 Amendment 1 to First Amended and Restated Loan and Security Agreement.
(18)

| Exhibit Number | Description of Exhibits |
|---------------------------|---|
| 10.6 (16) | Amendment 5 to Amended and Restated Platinum Plan Agreement. |
| 10.7 (16) | Agreement for IBM Global Financing Platinum Plan Invoice Discounting Schedule. |
| 10.8 (16) | Amendment No. 5 to Agreement for Inventory Financing. |
| 10.9 (1) | Industrial Lease Agreement between Shelby Drive Corporation and Priority Fulfillment Services, Inc. |
| 10.10 (1) | Lease Contract between Transports Weerts and Priority Fulfillment Services Europe B.V. |
| 10.11 (2) | Form of Change of Control Agreement between PFSweb, Inc. and each of its executive officers |
| 10.12 (4) | Ninth Amendment to Lease Agreement by and between AGBRI ATRIUM. L.P., and Priority Fulfillment Services, Inc. |
| 10.13 (5) | Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., Inventory Financing Partners, LLC and IBM Credit Corporation |
| 10.14 (5) | Amended and Restated Collateralized Guaranty by and between Priority Fulfillment Services, Inc. and IBM Credit Corporation |
| 10.15 (5) | Amended and Restated Guaranty to IBM Credit Corporation by PFSweb, Inc. |
| 10.16 (5) | Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation |
| 10.17 (5) | Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors Europe B.V., PFSweb B.V., and IBM Belgium Financial Services S.A. |
| 10.18 (5) | Amended and Restated Collateralized Guaranty between Priority Fulfillment Services, Inc. and IBM Belgium Financial Services S.A. |
| 10.19 (5) | Amended and Restated Guaranty to IBM Belgium Financial Services S.A. by PFSweb, Inc. |
| 10.20 (5) | Subordinated Demand Note by and between Supplies Distributors, Inc. and Priority Fulfillment Services, Inc. |

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- 10.21 Notes Payable Subordination Agreement between Congress Financial Corporation (Southwest) and
(5) Priority Fulfillment Services, Inc.
- 10.22 Guarantee in favor of Congress Financial Corporation (Southwest) by Business Supplies Distributors
(5) Holdings, LLC, Priority Fulfillment Services, Inc. and PFSweb, Inc.
- 10.23 General Security Agreement by Priority Fulfillment Services, Inc. in favor of Congress Financial
(5) Corporation (Southwest).
- 10.24 Inducement Letter by Priority Fulfillment Services, Inc. and PFSweb, Inc. in favor of Congress
(5) Financial Corporation (Southwest).
- 10.25 Form of Executive Severance Agreement between the Company and each of its executive officers.
(6)
- 10.26 Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors
(7) Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., Inventory
Financing Partners, LLC and IBM Credit Corporation
- 10.27 Amendment to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and
(7) among Supplies Distributors, S.A., Business Supplies Distributors Europe B.V., PFSweb B.V., and
IBM Belgium Financial Services S.A.
- 10.28 Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment
(7) Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation
- 10.29 Amendment to Factoring agreement dated March 29, 2002 between Supplies Distributors S.A. and
(7) Fortis Commercial Finance N.V.

| Exhibit Number | Description of Exhibits |
|-----------------------|--|
| 10.30 (8) | Loan and Security Agreement by and between Comerica Bank California (Bank) and Priority Fulfillment Services, Inc. (Priority) and Priority Fulfillment Services of Canada, Inc. (Priority Canada) |
| 10.31 (8) | Unconditional Guaranty of PFSweb, Inc. to Comerica Bank California |
| 10.32 (8) | Security Agreement of PFSweb, Inc. to Comerica Bank California |
| 10.33 (8) | Intellectual Property Security Agreement between Priority Fulfillment Services, Inc. and Comerica Bank California |
| 10.34 (8) | Amendment 2 to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors B.V., PFSweb B.V., and IBM Belgium Financial Services S.A. |
| 10.35 (8) | Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., and IBM Credit LLC |
| 10.36 (9) | Amendment to factoring agreement dated April 30, 2003 between Supplies Distributors S.A. and Fortis Commercial Finance N.V. |
| 10.37 (9) | Loan and Security Agreement by and between Congress Financial Corporation (Southwest), as Lender and Supplies Distributors, Inc., as Borrower dated March 29, 2002. |
| 10.38 (9) | General Security Agreement Business Supplies Distributors Holdings, LLC in favor of Congress Financial Corporation (Southwest) |
| 10.39 (9) | Stock Pledge Agreement between Supplies Distributors, Inc. and Congress Financial Corporation (Southwest) |
| 10.40 (9) | First Amendment to General Security Agreement by Priority Fulfillment Services, Inc. in favor of Congress Financial Corporation (Southwest) |
| 10.41 (10) | First Amendment to Loan and Security Agreement made as of September 11, 2003 by and between Priority Fulfillment Services, Inc., Priority Fulfillment Services of Canada, Inc. and Comerica Bank. |
| 10.42 (11) | Securities Purchase Agreement dated as of November 7, 2003 between PFSweb, Inc. and the Purchasers named therein. |
| 10.43 (11) | Form of Four Year Warrant dated as of November 7, 2003 issued to each of the Purchasers pursuant to the Securities Purchase Agreement. |
| 10.44 (12) | Industrial Lease Agreement between New York Life Insurance Company and Daisytex, Inc. |
| 10.45 (12) | |

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First Amendment to Industrial Lease Agreement between New York Life Insurance Company, Daisytek, Inc. and Priority Fulfillment Services, Inc.

- 10.46 (12) Second Amendment to Industrial Lease Agreement between ProLogis North Carolina Limited Partnership and Priority Fulfillment Services, Inc.
- 10.47 (12) Modification, Ratification and Extension of Lease between Shelby Drive Corporation and Priority Fulfillment Services, Inc.
- 10.48 (13) Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., and IBM Credit LLC
- 10.49 (13) Amendment 4 to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors B.V., PFSweb B.V., and IBM Belgium Financial Services S.A.
- 10.50 (13) Third Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation.
- 10.51 (13) First Amendment to Loan and Security Agreement by and between Congress Financial Corporation (Southwest), as Lender and Supplies Distributors, Inc., as Borrower.
- 10.52 (13) Form of Modification to Executive Severance Agreement.
- 10.53 (14) Industrial Lease Agreement by and between Industrial Developments International, Inc. and Priority Fulfillment Services, Inc.

| Exhibit Number | Description of Exhibits |
|---------------------------|--|
| 10.54 (14) | Guaranty by PFSweb, Inc. in favor of Industrial Developments International, Inc. |
| 10.55 (14) | Lease between Fleet National Bank and Priority Fulfillment Services, Inc. |
| 10.56 (14) | Guaranty by PFSweb, Inc. in favor of Fleet National Bank |
| 10.57 (14) | Amendment No. 3 to Lease dated as of March 3, 1999 between Fleet National Bank and Priority Fulfillment Services, Inc. |
| 10.58 (15) | Loan Agreement between Mississippi Business Finance Corporation and Priority Fulfillment Services, Inc. dated as of November 1, 2004 |
| 10.59 (15) | Placement Agreement between Priority Fulfillment Services, Inc., Comerica Securities and Mississippi Business Finance Corporation |
| 10.60 (15) | Reimbursement Agreement between Priority Fulfillment Services, Inc. and Comerica Bank |
| 10.61 (15) | First Amended and Restated Loan and Security Agreement by and between Comerica Bank and Priority Fulfillment Services, Inc. |
| 10.62 (15) | Remarketing Agreement between Priority Fulfillment Services, Inc. and Comerica Securities |
| 10.63 (21) | Amendment to factoring agreement dated December 12, 2005 between Supplies Distributors S.A. and Fortis Commercial Finance N.V. |
| 21 (21) | Subsidiary Listing |
| 23.1 (20) | Consent of KPMG LLP, Independent Registered Public Accounting Firm |
| 31.1 (20) | Certifications of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350 |
| 31.2 (20) | Certifications of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 |
| 32.1 (20) | Certifications of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| (1) | Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657). |

- (2) Incorporated by reference from PFSweb, Inc. Form 10-K for the fiscal year ended March 31, 2001
- (3) Incorporated by reference from PFSweb, Inc. Form 10-Q/A for the quarterly period ended September 30, 2001
- (4) Incorporated by reference from PFSweb, Inc. Form 10-K for the transition period ended December 31, 2001
- (5) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended March 31, 2002
- (6) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended June 30, 2002
- (7) Incorporated by reference from PFSweb, Inc. Form 10-K for the year ended December 31, 2002
- (8)

Incorporated by
reference from
PFSweb, Inc.
Form 10-Q for
the quarterly
period ended
March 31, 2003

(9) Incorporated by
reference from
PFSweb, Inc.
Form 10-Q for
the quarterly
period ended
June 30, 2003

(10) Incorporated by
reference from
PFSweb, Inc.
Form 10-Q for
the quarterly
period ended
September 30,
2003

(11) Incorporated by
reference from
PFSweb, Inc.
Report on Form
8-K filed on
November 10,
2003

(12) Incorporated by
reference from
PFSweb, Inc.
Form 10-K for
the year ended
December 31,
2003

(13) Incorporated by
reference from
PFSweb, Inc.
Form 10-Q for
the quarterly
period ended
March 31, 2004

(14) Incorporated by
reference from

PFSweb, Inc.
Form 10-Q for
the quarterly
period ended
September 30,
2004

- (15) Incorporated by reference from PFSweb, Inc. Form 10-K for the year ended December 31, 2004.
- (16) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended March 31, 2005.
- (17) Incorporated by reference from PFSweb, Inc. Report on Form 8-K filed on June 14, 2005.
- (18) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended June 30, 2005.
- (19) Incorporated by reference from PFSweb, Inc. Current Report on Form 8-K filed on November 30, 2005.
- (20) Filed herewith
- (21) Previously filed

SCHEDULE I

PFSWEB, INC. AND SUBSIDIARIES
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
BALANCE SHEETS PARENT COMPANY ONLY
(In thousands)

| | December 31, 2005 | December 31, 2004 |
|---|----------------------------------|----------------------------------|
| ASSETS: | | |
| Cash and cash equivalents | \$ 3/4 | \$ 3/4 |
| Receivable from Priority Fulfillment Services, Inc. | 3/4 | 4,771 |
| Investment in subsidiaries | 36,535 | 25,155 |
| | | |
| Total assets | \$ 36,535 | \$ 29,926 |
| | | |
| LIABILITIES: | | |
| Payable due to Priority Fulfillment Services, Inc. | \$ 6,601 | \$ 3/4 |
| | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock | 3/4 | 3/4 |
| Common stock | 23 | 22 |
| Additional paid-in capital | 58,736 | 56,645 |
| Accumulated deficit | (29,824) | (29,077) |
| Accumulated other comprehensive income | 1,084 | 2,421 |
| Treasury stock | (85) | (85) |
| | | |
| Total shareholders equity | 29,934 | 29,926 |
| | | |
| Total liabilities and shareholders equity | \$ 36,535 | \$ 29,926 |

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

SCHEDULE I

PFSWEB, INC. AND SUBSIDIARIES
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF OPERATIONS PARENT COMPANY ONLY
FOR THE YEARS ENDED DECEMBER 31
(In thousands)

| | 2005 | 2004 | 2003 |
|---|-------------|-------------|-------------|
| EQUITY IN NET INCOME (LOSS) OF CONSOLIDATED SUBSIDIARIES | \$ (747) | \$ 226 | \$ (3,746) |
| NET INCOME (LOSS) | \$ (747) | \$ 226 | \$ (3,746) |

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

SCHEDULE I

PFSWEB, INC. AND SUBSIDIARIES
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF CASH FLOWS PARENT COMPANY ONLY
FOR THE YEARS ENDED DECEMBER 31
(In thousands)

| | 2005 | 2004 | 2003 |
|---|-------------|-------------|-------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ (747) | \$ 226 | \$ (3,746) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | |
| Equity in net (income) loss of consolidated subsidiaries | 747 | (226) | 3,746 |
| Change in operating asset-investment in subsidiaries | (13,447) | | |
| Net cash provided by operating activities | (13,447) | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Net proceeds from issuance of common stock | 2,075 | 475 | 4,059 |
| Net increase/(decrease) in balance with Priority Fulfillment Services, Inc. | 11,372 | (475) | (4,081) |
| Net cash provided by/(used in) financing activities | 13,447 | | (22) |
| NET DECREASE IN CASH | | | (22) |
| CASH AND CASH EQUIVALENTS, beginning of period | | | 22 |
| CASH AND CASH EQUIVALENTS, end of period | \$ | \$ | \$ |

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

SCHEDULE II

PFSWEB, INC. AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS
FOR THE YEARS ENDED DECEMBER 31
(Amounts in thousands)

| | Balance at | Additions | | Deductions | Balance at |
|-------------------------------------|-------------------|------------------|-----------------|-------------------|-------------------|
| | Beginning | Charges | Charges | | End of |
| | of Period | to | to | | Period |
| | | Cost | Other | | |
| | | and | Accounts | | |
| | | Expenses | | | |
| Year Ended December 31, 2003: | | | | | |
| Allowance for doubtful accounts | \$ 411 | 351 | | (423) | \$ 339 |
| Allowance for slow moving inventory | \$ 142 | 1,984 | | (812) | \$ 1,314 |
| Income tax valuation allowance | \$ 10,207 | 1,197 | | | \$ 11,404 |
| Year Ended December 31, 2004: | | | | | |
| Allowance for doubtful accounts | \$ 339 | 289 | | (124) | \$ 504 |
| Allowance for slow moving inventory | \$ 1,314 | 1,204 | | (45) | \$ 2,473 |
| Income tax valuation allowance | \$ 11,404 | 346 | 475 | | \$ 12,225 |
| Year Ended December 31, 2005: | | | | | |
| Allowance for doubtful accounts | \$ 504 | 40 | | (60) | \$ 484 |
| Allowance for slow moving inventory | \$ 2,473 | (230) | | (704) | \$ 1,539 |
| Income tax valuation allowance | \$ 12,225 | 107 | 90 | | \$ 12,422 |

SIGNATURES

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

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

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

| Signature | Title | Date |
|-----------------------|--|----------------|
| /s/ MARK C. LAYTON | Chairman of the Board, President and Chief Executive Officer | March 31, 2006 |
| Mark C. Layton | (Principal Executive Officer) | |
| /s/ THOMAS J. MADDEN | Executive Vice President and Chief Financial and Accounting | March 31, 2006 |
| Thomas J. Madden | Officer (Principal Financial and Accounting Officer) | |
| /s/ DR. NEIL JACOBS | Director | March 31, 2006 |
| Dr. Neil Jacobs | | |
| /s/ TIMOTHY M. MURRAY | Director | March 31, 2006 |
| Timothy M. Murray | | |
| /s/ JAMES F. REILLY | Director | March 31, 2006 |
| James F. Reilly | | |
| /s/ DAVID I. BEATSON | Director | March 31, 2006 |
| David I. Beatson | | |