Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2005

OR

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

For the Transition Period from _______ to _______

Commission File Number 000-28275

PFSweb, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**75-2837058**
(State of Incorporation)	(I.R.S. Employer I.D. No.)
500 North Central Expressway, Plano, Texas	**75074**
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by a check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes o No ☑

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

At November 11, 2005 there were 22,526,681 shares of registrant's common stock outstanding, excluding 86,300 shares of common stock in treasury.

PFSWEB, INC. AND SUBSIDIARIES
Form 10-Q
September 30, 2005

INDEX

PART II. OTHER INFORMATION

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

PFSWEB, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	September 30, 2005 (Unaudited)	December 31, 2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 14,681	$ 13,592
Restricted cash	1,409	2,746
Accounts receivable, net of allowance for doubtful accounts of $444 and $504 at September 30, 2005 and December 31, 2004, respectively	45,059	41,565
Inventories, net	38,583	44,947
Other receivables	9,745	8,061
Prepaid expenses and other current assets	3,682	3,349
Total current assets	113,159	114,260
PROPERTY AND EQUIPMENT, net	12,995	14,264
RESTRICTED CASH	150	675
OTHER ASSETS	1,198	1,128
Total assets	$ 127,502	$ 130,327
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 20,849	$ 19,098
Trade accounts payable	58,306	61,583
Accrued expenses	10,224	10,971
Total current liabilities	89,379	91,652
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	6,551	7,232
OTHER LIABILITIES	1,976	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; 22,582,338 and 21,665,585 shares issued at September 30, 2005 and December 31, 2004, respectively; and 22,496,038 and 21,579,285 outstanding at September 30, 2005 and December 31, 2004, respectively	23	22
Additional paid-in capital	58,697	56,645
Accumulated deficit	(30,290)	(29,077)
Accumulated other comprehensive income	1,251	2,421
Treasury stock at cost, 86,300 shares	(85)	(85)
Total shareholders' equity	29,596	29,926
Total liabilities and shareholders' equity	$ 127,502	$ 130,327

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

PFSWEB, INC. AND SUBSIDIARIES

UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
REVENUES:				
Product revenue, net	$ 62,284	$ 61,561	$ 189,352	$ 195,435
Service fee revenue	14,891	11,599	45,274	29,764
Pass-through revenue	4,317	3,857	13,601	9,323
Total net revenues	81,492	77,017	248,227	234,522
COSTS OF REVENUES:				
Cost of product revenue	57,401	58,126	176,651	184,302
Cost of service fee revenue	10,990	7,647	33,860	19,614
Pass-through cost of revenue	4,317	3,857	13,601	9,323
Total costs of revenues	72,708	69,630	224,112	213,239
Gross profit	8,784	7,387	24,115	21,283
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	8,441	6,451	23,359	20,493
Income from operations	343	936	756	790
INTEREST EXPENSE, NET	532	373	1,325	1,125
Income (loss) before income taxes	(189)	563	(569)	(335)
INCOME TAX EXPENSE	264	143	644	533
NET INCOME (LOSS)	$ (453)	$ 420	$ (1,213)	$ (868)
NET INCOME (LOSS) PER SHARE:				
Basic	$ (0.02)	$ 0.02	$ (0.05)	$ (0.04)
Diluted	$ (0.02)	$ 0.02	$ (0.05)	$ (0.04)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	22,488	21,386	22,349	21,270
Diluted	22,488	23,071	22,349	21,270

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

PFSWEB, INC. AND SUBSIDIARIES

UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (1,213)	$ (868)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,607	3,509
Provision for doubtful accounts	(57)	235
Provision for excess and obsolete inventory	—	1,036
Deferred income taxes	76	(109)
Non-cash compensation expense	16	14
Changes in operating assets and liabilities:		
Accounts receivables	(4,669)	(5,805)
Inventories, net	4,701	382
Prepaid expenses, other receivables and other assets	(2,305)	(2,480)
Accounts payable, accrued expenses and other liabilities	(1,214)	5,030
Net cash provided by (used in) operating activities	(58)	944
	—	—
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(3,409)	(3,442)
Decrease in restricted cash	1,348	258
Net cash used in investing activities	(2,061)	(3,184)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on capital lease obligations	(890)	(793)
Decrease in restricted cash	514	727
Proceeds from issuance of common stock	2,036	303
Proceeds from debt	1,564	2,291
Net cash provided by financing activities	3,224	2,528
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(16)	(90)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,089	198
CASH AND CASH EQUIVALENTS, beginning of period	13,592	14,743
CASH AND CASH EQUIVALENTS, end of period	$ 14,681	$ 14,941
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under capital leases	$ 891	$ 1,490

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

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries, including Supplies Distributors, Inc., 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 Overview

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

Supplies Distributors Overview

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

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of September 30, 2005, and for the three and nine months ended September 30, 2005 and 2004, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and are unaudited. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim condensed consolidated financial statements of the Company include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the Company's financial position as of September 30, 2005, its results of operations for the three and nine months ended September 30, 2005 and 2004 and its results of cash flows for the nine months ended September 30, 2005 and 2004. Results of the Company's operations for interim periods may not be indicative of results for the full fiscal year.

Certain prior period data has been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net loss or shareholders' equity.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Concentration of Business and Credit Risk

The Company's product revenue was primarily generated by sales to customers of product purchased under master distributor agreements with one supplier. The Company's service fee revenue was generated under contractual service fee relationships with multiple clients.

Product sales to three customers accounted individually each for greater than 10%, and in the aggregate accounted for approximately 36%, of the Company's total product revenues for the nine months ended September 30, 2005. Service fee revenue from three clients individually accounted for approximately 29%, 15% and 13% of service fee revenue, excluding pass-through revenue, for the nine months ended September 30, 2005. On a consolidated basis, there was one customer/client that individually accounted for 11% of the Company's total revenues, excluding pass-through revenue, for the nine months ended September 30, 2005. As of September 30, 2005, two customers individually accounted for 14% and 11% of accounts receivable.

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 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, a service fee relationship, 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.

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. 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. The allowance for slow moving inventory was \$1.7 million and \$2.5 million at September 30, 2005 and December 31, 2004, 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 Company's property held under capital leases amounted to approximately \$2.8 million and \$3.0 million, net of accumulated amortization of approximately \$6.4 million and \$5.4 million, at September 30, 2005 and December 31, 2004, respectively.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

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, including FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation and Interpretation of APB No. 25*, issued in March 2000. 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 periods may not be representative of the pro forma effect for future periods due to the impact of vesting and potential future awards.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(In thousands, except per share amounts)			
Net income (loss) as reported	$ (453)	$ 420	$ (1,213)	$ (868)
Add: Stock-based non-employee compensation expense included in reported net income (loss)	2	—	16	14
Deduct: Total stock-based employee and non-employee compensation expense determined under fair value based method	(223)	(165)	(798)	(542)
Pro forma net income (loss), applicable to common stock for basic and diluted computations	$ (674)	$ 255	$ (1,995)	$ (1,396)
Income (loss) per common share – as reported				
Basic	$ (0.02)	$ 0.02	$ (0.05)	$ (0.04)
Diluted	$ (0.02)	$ 0.02	$ (0.05)	$ (0.04)
Income (loss) per common share – pro forma				
Basic	$ (0.03)	$ 0.01	$ (0.09)	$ (0.07)
Diluted	$ (0.03)	$ 0.01	$ (0.09)	$ (0.07)

During the nine months ended September 30, 2005, the Company issued an aggregate of 767,000 options to purchase shares of common stock to officers, directors, employees and consultants of the Company.

Impact of Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123, *Share-Based Payment* ("SFAS 123R") which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, ("SFAS 123") and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees.* 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 in the quarter ending March 31, 2006 and is currently evaluating SFAS 123R to determine the impact on its consolidated financial statements. However, the adoption is expected to have a negative effect on consolidated net income.

3. *COMPREHENSIVE INCOME (LOSS) (in thousands)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	$ (453)	$ 420	$ (1,213)	$ (868)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(85)	164	(1,170)	(208)
Comprehensive income (loss)	$ (538)	$ 584	$ (2,383)	$ (1,076)

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

4. ***NET INCOME (LOSS) PER COMMON SHARE***

Basic and diluted net income (loss) per common share is computed by dividing the net income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the reporting period. For the nine months ended September 30, 2005 and 2004, and the three months ended September 30, 2005 and 2004, outstanding options of 5.5 million, 5.0 million, 5.5 million and 1.4 million, respectively, to purchase common shares were anti-dilutive and have been excluded from the weighted diluted average share computation. For the three months ended September 30, 2004, the effect of dilutive stock options increased the number of weighted average shares outstanding by 1.7 million for computing diluted net income per share.

5. ***VENDOR FINANCING:***

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

	September 30, 2005	December 31, 2004
Inventory and working capital financing agreements:		
United States	$ 25,213	$ 26,962
Europe	9,496	13,110
Total	$ 34,709	$ 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. As of September 30, 2005, Supplies Distributors had $2.8 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, 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 all 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%. The facility also includes a monthly service fee. The Company has classified the outstanding amounts under this credit facility as accounts payable in the consolidated balance sheets.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors' European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. ("IBM Belgium") to finance their distribution of IBM products in Europe. The asset based credit facility with IBM Belgium provides up to 12.5 million Euros (approximately $15.1 million) in financing for purchasing IBM inventory and for certain other receivables. As of September 30, 2005, Supplies Distributors' European subsidiaries had 3.3 million euros ($4.0 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, 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 all 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 2.5%. Supplies

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

Distributors' European subsidiaries pay a monthly service fee on the commitment. The Company has classified the outstanding amounts under this credit facility that are collateralized by inventory as accounts payable in the consolidated balance sheets.

6. *DEBT AND CAPITAL LEASE OBLIGATIONS;*

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

	September 30, 2005	December 31, 2004
Loan and security agreements, United States Supplies Distributors	$ 12,339	$ 8,328
PFSweb	4,468	4,853
Factoring agreement, Europe	2,350	3,848
Taxable revenue bonds	5,000	5,000
Master lease agreements	2,914	3,141
Inventory and working capital financing agreement — Europe	—	682
Other	329	478
Total	27,400	26,330
Less current portion of long-term debt	20,849	19,098
Long-term debt, less current portion	$ 6,551	$ 7,232

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 September 30, 2005, Supplies Distributors had $6.2 million of available credit under this agreement. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement. Borrowings under the Congress facility accrue interest at prime rate plus 0.00% to 0.25% or Eurodollar rate plus 2.25% to 2.75%, dependent on excess availability, as defined. This agreement contains cross default provisions, various restrictions upon the ability of and Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, 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 customer remittances received in specified bank accounts. At September 30, 2005 and December 31, 2004, these bank accounts held $0.7 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, as amended, provides for up to $7.5 million of eligible accounts receivable financing ("Working Capital Advances") through March 2, 2007 and $2.5 million of equipment financing ("Equipment Advances") through June 15, 2008. Outstanding Working Capital Advances, $2.9 million as of September 30, 2005, accrue interest at prime rate plus 1%. Outstanding Equipment Advances, $1.6 million as of September 30, 2005, accrue interest at prime rate plus 1.5%. As of September 30, 2005, PFS had $4.2 million available credit under the Working Capital Advance portion and no available credit under the Equipment Advance portion of this facility. In October 2005, the Company repaid the $2.9 million of Working Capital Advances outstanding as of September 30, 2005. The Comerica Agreement contains cross default provisions, various restrictions upon PFS' ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, 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. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb. 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 $9.0 million) of eligible accounts receivables through March 2006. As of September 30, 2005, Supplies Distributors' European subsidiary had approximately 1.9 million euros ($2.3 million) of available credit under this agreement. Borrowings under this agreement can be either cash advances or straight loans, as defined. Cash advances accrue interest at 3.8% and straight loans accrue interest at Euribor plus 1.3%. This agreement contains various restrictions upon the ability of Supplies Distributors' European subsidiary to, among other things, merge, consolidate and incur indebtedness, as well as financial covenants, such as minimum net worth. This agreement is secured by a guarantee of Supplies Distributors, up to a maximum of 200,000 euros.

Taxable Revenue Bonds

PFSweb has a Loan Agreement with the Mississippi Business Finance Corporation (the "MBFC") in connection with the issuance by the MBFC of $5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the "Bonds"). The MBFC loaned the proceeds of the Bonds to PFSweb for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in one of the Company's Southaven, Mississippi distribution facilities. The Bonds bear interest at a variable rate, 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 an initial maturity date of December 2006 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. PFSweb has established a sinking fund account with Comerica, which at September 30, 2005 includes $0.2 million restricted for payment 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 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 ($0.8 million and $1.2 million as

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

of September 30, 2005 and December 31, 2004, respectively) are secured by the related equipment and letters of credit. The outstanding financing transactions ($0.3 million and $0.5 million as of September 30, 2005 and December 31, 2004, respectively) are secured by a letter of credit.

The Company has a master agreement with a leasing company that provided for leasing transactions of certain equipment. The amounts outstanding under this agreement as of September 30, 2005 and December 31, 2004 were $1.0 million and $1.2 million, respectively, and are secured by the related equipment.

The Company enters into other leasing and financing agreements 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.

7. *SEGMENT INFORMATION*

The Company is organized into two operating segments: PFSweb is an international provider of integrated business process outsourcing solutions and operates as a service fee business; Supplies Distributors is a master distributor of primarily IBM products.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues (in thousands):				
PFS	$ 21,476	$ 17,308	$ 65,674	$ 44,970
Supplies Distributors	62,284	61,561	189,352	195,435
Eliminations	(2,268)	(1,852)	(6,799)	(5,883)
	$ 81,492	$ 77,017	$ 248,227	$ 234,522
Income from operations (in thousands):				
PFS	$ (1,990)	$ (337)	$ (4,346)	$ (3,394)
Supplies Distributors	2,333	1,273	5,102	4,177
Eliminations	—	—	—	7
	$ 343	$ 936	$ 756	$ 790
Depreciation and amortization (in thousands):				
PFS	$ 1,595	$ 1,173	$ 4,607	$ 3,502
Supplies Distributors	—	—	—	14
Eliminations	—	—	—	(7)
	$ 1,595	$ 1,173	$ 4,607	$ 3,509
Capital expenditures (in thousands):				
PFS	$ 848	$ 1,645	$ 3,409	$ 3,442
Supplies Distributors	—	—	—	—
Eliminations	—	—	—	—
	$ 848	$ 1,645	$ 3,409	$ 3,442

	September 30, 2005	December 31, 2004
Assets (in thousands):		
PFS	$ 58,709	$ 56,610
Supplies Distributors	84,206	88,548
Eliminations	(15,413)	(14,831)
	$ 127,502	$ 130,327

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Condensed Consolidated Financial Statements

8. *COMMITMENTS AND CONTINGENCIES*

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 2004 and 2005. The Company has not accrued for the additional taxes, which through September 30, 2005 could be $0.4 million to $0.5 million for 2004 and $0.4 million for 2005, as it does not believe that it is probable that an additional assessment will be incurred.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek's Plan of Liquidation. The complaint alleges, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. The Company believes the claim has no merit and 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 September 30, 2005, an aggregate of approximately $0.9 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.

9. *SUBSEQUENT EVENT*

On November 10, 2005 the Company and eCOST.com, Inc., a multi-category online discount retailer of new, “close-out” and refurbished brand-name merchandise for consumers and small business buyers, announced that they had entered into a non-binding Letter of Intent (LOI) for the merger of the Company and eCOST.com. Under the terms of the proposed merger, the Company will issue to eCOST.com shareholders one Company common share for each outstanding share of eCOST.com in a tax-free, share-for-share transaction. As a result, eCOST.com will become a wholly owned subsidiary of PFSweb. The proposed merger is subject to both companies' due diligence, the negotiation and execution of a definitive merger agreement, the approval of both companies' respective Boards of Directors and shareholders and other customary conditions. No assurance can be given as to the final terms of, or the consummation of, the proposed merger or any transaction.

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

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

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like "seek," "strive," "believe," "expect," "anticipate," "predict," "potential," "continue," "will," "may," "could," "intend," "plan," "target" and "estimate" or similar expressions, we are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K for the year ended December 31, 2004, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

- our ability to retain and expand relationships with existing clients and attract and implement new clients;
- our reliance on the fees generated by the transaction volume or product sales of our clients;
- our reliance on our clients' projections or transaction volume or product sales;
- our dependence upon our agreements with IBM;
- our dependence upon our agreements with our major clients;
- our client mix, their business volumes and the seasonality of their business;
- our ability to finalize pending contracts;
- the impact of strategic alliances and acquisitions;
- trends in the market for our services;
- trends in e-commerce;
- whether we can continue and manage growth;
- changes in the trend toward outsourcing;
- increased competition;
- our ability to generate more revenue and achieve sustainable profitability;
- effects of changes in profit margins;
- the customer and supplier concentration of our business;
- the unknown effects of possible system failures and rapid changes in technology;
- trends in government regulation both foreign and domestic;
- foreign currency risks and other risks of operating in foreign countries;
- potential litigation;
- our dependency on key personnel;
- the impact of new accounting standards and rules regarding revenue recognition, stock options and other matters;
- changes in accounting rules or the interpretations of those rules;
- our ability to raise additional capital or obtain additional financing; and
- our ability or the ability of our subsidiaries to borrow under current financing arrangements and maintain compliance with debt covenants.

We have based these statements on our current expectations about future events. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future. There may be additional risks that we do not currently view as material or that are not presently known.

Overview

We are an international provider of integrated business process outsourcing solutions to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional business and e-commerce initiatives. We derive our revenues from a broad range of services, including professional consulting, technology collaboration, order management, managed web hosting and web development, customer relationship management, financial services including billing and collection services and working capital solutions, kitting and assembly services, information management and international fulfillment and distribution services. We offer our services as an integrated solution, which enables our clients to outsource their complete infrastructure needs to a single source and to focus on their core competencies. Our distribution services are conducted at warehouses that we lease or manage and include real-time inventory management and customized picking, packing and shipping of our clients' customer orders. We currently offer the ability to provide infrastructure and distribution solutions to clients that operate in a range of vertical markets, including technology manufacturing, computer products, printers, cosmetics, fragile goods, high security collectibles, pharmaceuticals, contemporary home furnishings, apparel, aviation, telecommunications and consumer electronics, among others.

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

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

Our second business segment is a product revenue model. In this segment, we are a master distributor of product for IBM and certain other clients. In this capacity, we purchase, and thus own, inventory and recognize the corresponding product revenue. As a result, upon the sale of inventory, we own the accounts receivable. Freight costs billed to customers are reflected as components of product revenue. This business segment requires significant working capital requirements, for which we have senior credit facilities to provide for more than $80 million of available financing.

Growth is a key element to achieving our future goals, including maintaining sustainable profitability. Growth in our service fee business is driven by two main elements: new client relationships and organic growth from existing clients. During 2004, we were successful in winning new service fee contracts with new and existing clients. We currently believe these new contracts, once fully operational, will generate annual service fee revenue of more than $20 million. We expect to invoice 85% — 90% of the estimated annual run-rate revenue of these new contracts during 2005. Our results for the three months and nine months ended September 30, 2005 include approximately $5.5 million and $14.3 million, respectively, of new service fee revenue.

We continue to monitor and control our costs to focus on profitability. While we expect our new service fee contracts to yield increased gross profit, we expect this profit to be somewhat offset by incremental investments to implement new contracts, investments in infrastructure and sales and marketing to support our targeted growth and increased public company professional fees.

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

Cost of product revenue — cost of product revenue consists of the purchase price of product sold and freight costs, which are reduced by certain reimbursable expenses. These reimbursable expenses include pass-through customer marketing programs, direct costs incurred in passing on any price decreases offered by 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 under the master distributor agreements.

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

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

SG&A expenses — consist primarily of compensation and related expenses for sales and marketing staff, executive, management and administrative personnel and other overhead costs, including certain occupancy and information technology costs and depreciation and amortization expenses. In addition, certain direct contract costs related to our IBM and other master distributor agreements are reflected as selling and administrative expenses.

Monitoring and controlling our available cash balances continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. In recent years we have added to our available cash and liquidity positions through various transactions. First we have a working capital financing agreement with a bank that currently provides financing for up to $7.5 million of eligible accounts receivable and has provided financing for $2.5 million of eligible capital expenditures. Secondly, in 2003 we completed a private placement of approximately 1.6 million shares of our common stock to certain investors that provided net proceeds of approximately $3.2 million. In January 2005, we issued an additional 0.4 million shares of common stock to certain of these investors who exercised warrants issued in the private placement. The warrants exercised provided $1.3 million of additional proceeds. Thirdly, in 2004 we received proceeds of $5 million of taxable revenue bonds to finance capital additions to one of our new facilities in Southaven, MS.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Unaudited)	2004 (Unaudited)	2005 (Unaudited)	2004 (Unaudited)
Product revenue, net	76.4%	79.9%	76.3%	83.3%
Service fee revenue	18.3	15.1	18.2	12.7
Pass-through revenue	5.3	5.0	5.5	4.0
Total revenues	100.0	100.0	100.0	100.0
Cost of product revenue (as % of product revenue)	92.2	94.4	93.3	94.3
Cost of service fee revenue (as % of service fee revenue)	73.8	65.9	74.8	65.9

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Cost of pass-through revenue (as % of pass-through revenue)	100.0	100.0	100.0	100.0
Total costs of revenues	89.2	90.4	90.3	90.9
Gross profit	10.8	9.6	9.7	9.1
Selling, general and administrative expenses	10.4	8.4	9.4	8.7
Income (loss) from operations	0.4	1.2	0.3	0.4
Interest expense, net	0.6	0.5	0.5	0.5
Income (loss) before income taxes	(0.2)	0.7	(0.2)	(0.1)
Income tax expense	0.3	0.2	0.3	0.2
Net income (loss)	(0.5)%	0.5%	(0.5)%	(0.3)%

Results of Operations for the Three and Nine Months Ended September 30, 2005 and 2004

Product Revenue. Product revenue was $62.3 million for the three months ended September 30, 2005, as compared to $61.6 million for the three months ended September 30, 2004, an increase of $0.7 million, or 1.2%. This increase was primarily due to the impact of certain product price increases in 2005 offset by a decrease in sales volume. Product revenue was $189.4 million for the nine months ended September 30, 2005, as compared to $195.4 million for the nine months ended September 30, 2004, a decrease of $6.0 million, or 3.1%. The nine-month decrease in product revenue resulted primarily from the decreased sales volume of certain product partially offset by the impact of certain product price increases and the effect of exchange rates in our European and Canadian operations.

Service Fee Revenue. Service fee revenue was $14.9 million for the three months ended September 30, 2005 as compared to $11.6 million for the three months ended September 30, 2004, an increase of $3.3 million or 28.4%. For the nine month period ended September 30, 2005 and 2004, service fee revenue was $45.3 million and $29.8 million respectively, an increase of $15.5 million or 52.1%. The change in service fee revenue is shown below ($ millions):

	Three Months	Nine Months
Period ended September 30, 2004	$ 11.6	$ 29.8
New service contract relationships, including certain incremental projects under new contracts	5.5	14.3
Increase (decrease) in existing client service fees including impact of certain incremental projects with existing clients	(2.1)	2.6
Terminated clients not included in 2005 revenue	(0.1)	(1.4)
Period ended September 30, 2005	$ 14.9	$ 45.3

The decrease in existing client service fees during the three months ended September 30, 2005 primarily resulted from one of our large clients modifying its product release schedule as well as lower project revenue in 2005.

Cost of Product Revenue. Cost of product revenue was $57.4 million for the three months ended September 30, 2005, as compared to $58.1 million for the three months ended September 30, 2004, a decrease of $0.7 million or 1.2%. Cost of product revenue as a percent of product revenue was 92.2% and 94.4% during the three months ended September 30, 2005 and 2004, respectively. The resulting gross profit margin was 7.8% and 5.6% for the three months ended September 30, 2005 and 2004, respectively. For the nine month period ended September 30, 2005 and 2004, cost of product revenue was $176.7 million and $184.3 million, respectively, a decrease of $7.6 million or 4.1%. Cost of product revenue as a percent of product revenue was 93.3% and 94.3% during the nine months ended September 30, 2005 and 2004, respectively. The resulting gross profit margin was 6.7% and 5.7% for the three and nine months ended September 30, 2005 and 2004, respectively. Cost of product revenue for the three and nine months ended September 30, 2005 was reduced by certain incremental inventory cost reductions and also the result of decreased sales volumes of certain products. In addition, for the three and nine months ended September 30, 2004, gross margin included higher provisions for excess and obsolete inventory of $0.3 million and $1.0 million, respectively, as compared to the comparable periods in 2005.

Cost of Service Fee Revenue. Cost of service fee revenue was $11.0 million for the three months ended September 30, 2005, as compared to $7.6 million during the three months ended September 30, 2004, an increase of $3.4 million or 43.7%. The resulting service fee gross profit was $3.9 million, or 26.2% of service fee revenue, during the three months ended September 30, 2005 as compared to $4.0 million, or 34.1% of service fee revenue for the three months ended September 30, 2004. Cost of service fee revenue was $33.9 million for the nine months ended September 30, 2005, as compared to $19.6 million during the nine months ended September 30, 2004, an increase of $14.3 million or 72.6%. The resulting service fee gross profit was $11.4 million, or 25.2% of service fee revenue, during the nine months ended September 30, 2005 as compared to $10.2 million, or 34.1% of service fee revenue for the nine months ended September 30, 2004. Our gross profit as a percent of service fees decreased in the current periods primarily due to lower gross margins on certain new contracts partially due to higher costs incurred during the implementation and initial operating periods of these new contracts. The three and nine months ended September 30, 2004 also reflects the higher gross margin benefit related to certain project revenue that has not occurred at a similar level in the corresponding period of 2005. As we add new service fee revenue in the future, we currently intend to target the underlying contracts to earn an average gross profit percentage of 25-35%, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors.

Selling, General and Administrative Expenses. SG&A expenses were $8.4 million for the three months ended September 30, 2005, or 10.4% of total revenues, as compared to $6.5 million, or 8.4% of total revenues, for the three months ended September 30, 2004. SG&A expenses were $23.4 million for the nine months ended September 30, 2005, or 9.4% of total revenues, as compared to $20.5 million, or 8.7% of total revenues, for the nine months ended September 30, 2004. The increase in SG&A expenses is primarily due to approximately $1.2 and $1.4 million for the three and nine months ended September 30, 2005, respectively, of incremental costs incurred to relocate certain of our operations from Memphis, TN to a new facility in Southaven, MS, the increase in legal fees related to the Daisytek lawsuit filed in May 2005 (see part II. Other Information, Item 1. Legal Proceedings), incremental sales and marketing expenses and certain personnel related costs.

Income Taxes. We recorded an income tax provision of $0.3 million and $0.1 million for the three months ended September 30, 2005 and 2004, respectively. For the nine months ended September 30, 2005 and 2004, we recorded a tax provision of $0.6 million and $0.5 million, respectively. The tax provision is primarily associated with our subsidiary Supplies Distributors' Canadian and European operations. We did not record an income tax benefit associated with our consolidated net loss in our U.S. operations. A valuation allowance has been provided for our net deferred tax assets as of September 30, 2005, which are primarily related to our net operating loss carryforwards. We did not record an income tax benefit for our PFSweb Canadian pre-tax losses in the current or prior periods. We anticipate that we will continue to record an income tax provision associated with Supplies Distributors' Canadian and European results of operations.

Liquidity and Capital Resources

Net cash used in operating activities was $0.1 million for the nine months ended September 30, 2005 resulting from an increase in accounts receivable of $4.7 million, an increase in prepaid expenses, other receivables and other costs of $2.3 million, and a $1.2 million decrease in accounts payable, accrued expenses and other liabilities offset by net income, as adjusted for non-cash items, of $3.4 million and a $4.7 million decrease in inventories. The increase in accounts receivable was primarily due to increased service fee billings for certain client relationships, the timing of payments received by certain clients and timing of certain product sales in September 2005. Net cash provided by operating activities was $0.9 million for the nine months ended September 30, 2004, and primarily resulted from net income, as adjusted for non-cash items of $3.8 million and an increase in accounts payable, accrued expenses and other liabilities of $5.0 million partially offset by increases in accounts receivable of $5.8 million and prepaid expenses, other receivables and other assets of $2.5 million.

Net cash used in investing activities for the nine months ended September 30, 2005 totaled $2.1 million, representing capital expenditures partially offset by a decrease in restricted cash. Net cash used in investing activities for the nine months ended September 30, 2004 totaled $3.2 million, primarily representing capital expenditures. Capital expenditures have historically consisted primarily of additions to upgrade our management information systems, and general expansion of our facilities, both domestic and foreign. We expect to incur capital expenditures to support new contracts and anticipated future growth opportunities. Based on our current client business activity and our targeted growth plans, we anticipate that our total investment in upgrades and additions to facilities and information technology services for the upcoming twelve months will be approximately $7 to $10 million, although additional capital expenditures may be necessary to support the infrastructure requirements of new clients. To maintain our current operating cash position, a portion of these expenditures may be financed through debt, operating or capital leases or additional equity. We may elect to modify or defer a portion of such anticipated investments in the event that we do not obtain the financing or achieve the revenue necessary to support such investments.

Net cash provided by financing activities was approximately $3.2 million for the nine months ended September 30, 2005, primarily representing $2.0 million from the issuance of common stock pursuant to our employee stock purchase and stock option programs and warrant exercises and $1.6 million of proceeds from debt. Net cash provided by financing activities was approximately $2.5 million for the nine months ended September 30, 2004, primarily representing $2.3 million of proceeds from debt.

During the nine months ended September 30, 2005, our working capital increased to $23.8 million from $22.6 million at December 31, 2004, primarily as a result of the issuance of common stock due to the exercise of certain warrants. To obtain additional financing in the future, in addition to our current cash position, we plan to evaluate various financing alternatives including the sale of equity, utilizing capital or operating leases, borrowing under our credit facilities, expanding our current credit facilities, entering into new debt agreements or transferring to third parties a portion of our subordinated loan balance due from Supplies Distributors. In conjunction with certain of these alternatives, we may be required to provide certain letters of credit to secure these arrangements. No assurances can be given that we will be successful in obtaining any additional financing or the terms thereof. We currently believe that our cash position, financing available under our credit facilities and funds generated from operations (including our anticipated revenue growth and/or cost reductions to offset lower than anticipated revenue growth) will satisfy our presently known operating cash needs, our working capital and capital expenditure requirements, our lease obligations, and additional subordinated loans to our subsidiary Supplies Distributors, if necessary, for at least the next twelve months.

The following is a schedule of our total contractual cash obligations as of September 30, 2005, which is comprised of operating leases, debt (including vendor financing) and capital leases, including interest (in millions):

	Payments Due By Period				
Contractual Obligations	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Debt	$ 59,360	$ 54,363	$ 1,797	$ 3,200	$ —
Capital lease obligations	2,975	1,312	1,443	220	—
Operating leases	22,325	7,442	10,689	3,394	800
Total	$ 84,660	$ 63,117	$ 13,929	$ 6,814	$ 800

In support of certain debt instruments and leases, as of September 30, 2005, we had $0.9 million of cash restricted as collateral for letters of credit. The letters of credit expire at various dates through March 2007, the related debt and lease obligations termination dates. In addition, as described above, we have provided collateralized guarantees to secure the repayment of certain Supplies Distributors' credit facilities. Many of our debt facilities include both financial and non-financial covenants, and also include cross default provisions applicable to other agreements. To the extent we fail to comply with our debt covenants, including the monthly financial covenant requirements and our required level of shareholders' equity, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. Any requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of September 30, 2005, we were in compliance with all debt covenants and we believe that we will maintain such compliance throughout calendar year 2005. Other than those noted herein, we do not have any other material financial commitments, although future client contracts may require capital expenditures and lease commitments to support the services provided to such clients.

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

Supplies Distributors has a short-term credit facility with IBM Credit LLC ("IBM Credit") and its European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. ("IBM Belgium") to finance their distribution of IBM products. We have provided a collateralized guaranty to secure the repayment of these credit facilities. The asset-based credit facilities provide financing for up to $30.5 million and up to 12.5 million Euros (approximately $15.1 million) with IBM Credit and IBM Belgium, respectively. These agreements expire in March 2006.

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

Supplies Distributors' European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. ("Fortis") to provide factoring for up to 7.5 million Euros (approximately $9.0 million) of eligible accounts receivables through March 29, 2006. Borrowings under this agreement can be either cash advances or straight loans, as defined.

These credit facilities contain cross default provisions, various restrictions upon the ability of Supplies Distributors and its subsidiaries to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as cash flow from operations, annualized revenue to working capital, net profit after tax to revenue, minimum net worth and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, we are required to maintain a subordinated loan to Supplies Distributors of no less than $7.0 million, maintain restricted cash of less than $5.0 million, are restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure and a minimum shareholders' equity of at least $18.0 million. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors or its subsidiaries under these facilities if they are unable to do so. We have also provided a guarantee of the obligations of Supplies Distributors and its subsidiaries to IBM, excluding the trade payables that are financed by IBM credit.

Our subsidiary, Priority Fulfillment Services, Inc. ("PFS"), has entered into a Loan and Security Agreement with Comerica Bank ("Comerica"), which, as amended, provides for up to $7.5 million of eligible accounts receivable financing through March 2007, and up to $2.5 million of eligible equipment purchases through June 2008. As of September 30, 2005, there were $4.2 million of funds available for accounts receivable financing and no available credit under the equipment purchasing financing. We entered this Agreement to supplement our existing cash position, and provide funding for our future operations, including our targeted growth. The Agreement contains cross default provisions, various restrictions upon our ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, and a minimum liquidity ratio, as defined. The agreement also limits our ability to increase the subordinated loan to Supplies Distributors to more than $8.0 million without the lender's approval. The agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb.

In 2003, we entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which we issued and sold an aggregate of 1.6 million shares of our common stock, par value $.001 per share (the "Common Stock"), at $2.16 per share, resulting in gross proceeds of $3.4 million. After deducting expenses, the net proceeds were approximately $3.2 million. In addition to the Common Stock, the investors received one-year warrants to purchase an aggregate 525,692 shares of Common Stock at an exercise price of $3.25 per share and four-year warrants to purchase an aggregate of 395,486 shares of Common Stock at an exercise price of $3.30 per share. In January 2005, 394,865 of the one-year warrants were exercised prior to their expiration, generating net proceeds to us of $1.3 million.

In 2004, to fulfill our obligations under certain new client relationships, we entered into a three-year operating lease arrangement for a new distribution facility in Southaven, MS, near our existing distribution complex in Memphis, TN. We have incurred approximately $5 million in capital expenditures to support the incremental business in this new distribution center. We financed a significant portion of these expenditures via a Loan Agreement with the Mississippi Business Finance Corporation (the “MBFC”) pursuant to which the MBFC issued $5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the “Bonds”). The MBFC loaned us the proceeds of the Bonds for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in our new Southaven, Mississippi distribution facility. The primary source of repayment of the Bonds is a letter of credit (the “Letter of Credit”) in the initial face amount of $5.1 million issued by Comerica pursuant to a Reimbursement Agreement between us and Comerica under which we are obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has an initial maturity date of December 2006 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof.

We receive municipal tax abatements in certain locations. During 2004 we received notice from a municipality that we did not satisfy certain criteria necessary to maintain the abatements. We plan to dispute the notice. If the dispute is not resolved favorably, we could be assessed additional taxes for calendar years 2004 and 2005. We have not accrued for the additional taxes, which through September 30, 2005 could be $0.4 million to $0.5 million for 2004 and $0.4 million for 2005, as we do not believe that it is probable that an additional assessment will be incurred.

In April 2005, we entered into a five-year operating lease arrangement for a new distribution facility in Southaven, MS, near our existing facility in Southaven, MS. We completed the move to the new facility in September 2005, and in doing so incurred incremental costs of approximately $1.54 million, which includes approximately $0.4 million related to a lease termination.

On May 9, 2005, a lawsuit was filed in the District Court of Collin County, Texas, by J. Gregg Pritchard, as Trustee of the D.I.C. Creditors Trust, naming the former directors of Daisytek International Corporation and the Company as defendants. Daisytek filed for bankruptcy in May 2003 and the Trust was created pursuant to Daisytek’s Plan of Liquidation. The complaint alleges, among other things, that the spin-off of the Company from Daisytek in December 1999 was a fraudulent conveyance and that Daisytek was damaged thereby in the amount of at least $38 million. We believe the claim has no merit and intend 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 September 30, 2005, an aggregate of approximately $0.9 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.

Seasonality

The seasonality of our business is dependent upon the seasonality of our clients’ business and sales of their products. Accordingly, our management must rely upon the projections of our clients in assessing quarterly variability. We believe that with our current client mix and their current business volumes, our service fee business activity was at it lowest in the quarter ended March 31. However due to product release schedule changes from certain of our clients, we believe this seasonal impact will not be as significant in 2005 as it has been in prior years. We anticipate that our product revenue will be highest during the quarter ended December 31.

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

Inflation

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

Critical Accounting Policies

A description of critical accounting policies is included in Note 2 to the accompanying unaudited interim condensed consolidated financial statements. For other significant accounting policies, see Note 2 to the consolidated financial statements in our December 31, 2004 Annual Report on Form 10-K.

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

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

Interest Rate Risk

Our interest rate risk is limited to our outstanding balances on our inventory and working capital financing agreements, taxable revenue bonds, loan and security agreements and factoring agreement for the financing of inventory, accounts receivable and certain other receivables and certain equipment, which amounted to $59.1 million at September 30, 2005. A 100 basis point movement in interest rates would result in approximately $0.3 million annualized increase or decrease in interest expense based on the outstanding balance of these agreements at September 30, 2005.

Foreign Exchange Risk

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

ITEM 4. Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of management, including our Chief Executive Officer and Principal Financial and Accounting Officer, within 90 days prior to the filing date of this report. Based upon the evaluation, our Chief Executive Officer and Principal Financial and Accounting Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic Securities and Exchange Commission filings. No significant changes were made to our internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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.

ITEM 2. Changes in Securities and Use of Proceeds

None

ITEM 3. Defaults Upon Senior Securities

None

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

None

ITEM 5. Other Information

None

ITEM 6. Exhibits and Reports on Form 8-K

a) Exhibits:

Exhibit No.	Description of Exhibits
3.1*	Amended and Restated Certificate of Incorporation
3.2*	Amended and Restated Bylaws
31.1**	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2**	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657).

** Filed herewith.

b) Reports on Form 8-K:

Form 8-K filed on July 6, 2005 reporting item 1.01, Entry Into a Material Definitive Agreement, between Supplies Distributors, Inc. and IBM Credit LLC to increase the line of credit from $27,500,000 to $30,500,000.

Form 8-K furnished on August 15, 2005 reporting Item 12, Results of Operations and Financial Condition, that on August 15, 2005, PFSweb, Inc. issued a press release announcing its financial results for the quarter ended June 30, 2005

Table of Contents

SIGNATURES

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

Date: November 14, 2005

PFSweb, Inc.

By: /s/ Thomas J. Madden

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

Table of Contents

INDEX TO EXHIBIT

Exhibit No.	Description of Exhibits
3.1*	Amended and Restated Certificate of Incorporation
3.2*	Amended and Restated Bylaws
31.1**	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2**	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657).

** Filed herewith.

c) Reports on Form 8-K:

Form 8-K filed on July 6, 2005 reporting item 1.01, Entry Into a Material Definitive Agreement, between Supplies Distributors, Inc. and IBM Credit LLC to increase the line of credit from $27,500,000 to $30,500,000.

Form 8-K furnished on August 15, 2005 reporting Item 12, Results of Operations and Financial Condition, that on August 15, 2005, PFSweb, Inc. issued a press release announcing its financial results for the quarter ended June 30, 2005

EXHIBIT 31.1

CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER

PURSUANT TO 18 U.S.C. SECTION 1350

I, Mark Layton, certify that:

1. I have reviewed this report on Form 10-Q of PFSweb, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operation and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2005

By: /s/ Mark C. Layton
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER

PURSUANT TO 18 U.S.C. SECTION 1350

I, Tom Madden, certify that:

1. I have reviewed this report on Form 10-Q of PFSweb, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operation and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2005

By: /s/ Thomas J. Madden
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATIONS PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), each of the undersigned officers of PFSweb, Inc. (the “Company”), does hereby certify that:

The Quarterly Report on Form 10-Q for the period ended September 30, 2005 (the “Form 10-Q”) of the Company fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company as of, and for, the periods presented in the Form 10-Q.

November 14, 2005

/s/ Mark C. Layton
Mark C. Layton
Chief Executive Officer

November 14, 2005

/s/ Thomas J. Madden
Thomas J. Madden
Chief Financial Officer

The foregoing certification is being furnished as an exhibit to the Form 10-Q pursuant to Item 601(b)(32) of Regulation S-K and Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and, accordingly, is not being filed as part of the Form 10-Q for purposes of Section 18 of the Securities Exchange Act of 1934, as whether made before or after the date hereof, regardless of any general incorporation language in such filing.

A signed original of this written statement required by Section 906 has been provided to PFSweb, Inc. and will be retained by PFSweb, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.