

PFSWEB INC
Form 10-K/A
September 29, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K/A
(Amendment No. 1)

☐ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008

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)*

75-2837058
*(I.R.S. Employer
Identification Number)*

500 North Central Expressway, Plano, Texas
(Address of principal executive offices)

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 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. ☒

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

Large accelerated
filer ☐

Accelerated
filer ☐

Non-accelerated filer ☒
(Do not check if a Smaller reporting
company)

Smaller Reporting
Company ☒

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Indicated 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, 2008 (based on the closing price as reported by the National Association of Securities Dealers Automated Quotation System) was \$38,855,038.

At March 31, 2009, there were 9,942,140 shares of the registrant's Common Stock issued, \$.001 par value, (after giving effect to the 1-for-4.7 common share reverse stock split effective June 2, 2008).

EXPLANATORY NOTE

PFSweb, Inc, (the Company) is filing this Form 10-K/A Amendment No. 1 to its 2008 Annual Report on Form 10-K originally filed on March 31, 2009, (the 2008 Form 10-K), solely to correct certain inadvertent omissions from the certifications required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 included as Exhibits 31.1 and 31.2 to the 2008 Form 10-K. Pursuant to Item 246.13 of the SEC Compliance and Disclosure Interpretations: Regulation S-K, this Form 10-K/A includes only Items 8, 9A and 15 and the required consents and certifications. This Form 10-K/A does not reflect events occurring after the filing of the 2008 Form 10-K on March 31, 2009 and no attempt has been made in this Annual Report on Form 10-K/A to modify or update other disclosures as presented in the 2008 10-K. Accordingly, this Form 10-K/A should be read in conjunction with our filings with the SEC subsequent to the filing of the 2008 Form 10-K.

Unless otherwise indicated, all references to PFSweb, the Company, we, us and our refer to PFSweb, Inc., a Delaware corporation, and its subsidiaries.

Item 8. Financial Statements and Supplementary Data

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FINANCIAL STATEMENT SCHEDULES**

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

PFSweb, Inc.:

We have audited the accompanying consolidated balance sheet of PFSweb, Inc. (a Delaware corporation) and subsidiaries as of December 31, 2008, and the related consolidated statements of operations, shareholders' equity and comprehensive loss, and cash flows for the year ended December 31, 2008. Our audit of the basic financial statements included the financial statement schedules listed in the index appearing under Item 15(a) (1). These financial statements and the financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audit.

We conducted our audit 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. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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, 2008, and the results of their operations and their cash flows for the year ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

Dallas, Texas

March 31, 2009

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

PFSweb, Inc.:

We have audited the accompanying consolidated balance sheet of PFSweb, Inc. and subsidiaries as of December 31, 2007, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for each of the years in the two-year period ended December 31, 2007. In connection with our audits of the consolidated financial statements, we also have audited financial statement schedules I to II. 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, 2007, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Dallas, Texas

March 31, 2008, except as it relates to the reverse stock split described in note 2, as to which the date is March 30, 2009

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

	December 31, 2008	December 31, 2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 16,050	\$ 14,272
Restricted cash	2,008	2,021
Accounts receivable, net of allowance for doubtful accounts of \$980 and \$1,483 at December 31, 2008 and 2007, respectively	44,546	48,493
Inventories, net of reserves of \$2,124 and \$2,080 at December 31, 2008 and 2007, respectively	47,186	46,392
Other receivables	13,072	10,372
Prepaid expenses and other current assets	3,802	2,608
Total current assets	126,664	124,158
PROPERTY AND EQUIPMENT, net	12,106	11,918
IDENTIFIABLE INTANGIBLES, net	961	5,824
GOODWILL	3,602	15,362
OTHER ASSETS	1,188	911
Total assets	\$ 144,521	\$ 158,173

LIABILITIES AND SHAREHOLDERS EQUITY

CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	\$ 22,251	\$ 22,238
Trade accounts payable	61,988	56,975
Accrued expenses	21,054	22,438
Total current liabilities	105,293	101,651
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	4,951	6,378
OTHER LIABILITIES	1,192	1,302
Total liabilities	111,436	109,331

COMMITMENTS AND CONTINGENCIES

SHAREHOLDERS EQUITY:

Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued and outstanding

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Common stock, \$0.001 par value; 75,000,000 shares authorized; 9,935,095 and 9,909,401 shares issued at December 31, 2008 and 2007, respectively; and 9,916,734 and 9,891,040 outstanding at December 31, 2008 and 2007, respectively

	10	10
Additional paid-in capital	92,728	92,121
Accumulated deficit	(61,393)	(45,738)
Accumulated other comprehensive income	1,825	2,534
Treasury stock at cost, 18,361 shares	(85)	(85)
Total shareholders' equity	33,085	48,842

Total liabilities and shareholders' equity	\$ 144,521	\$ 158,173
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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)

	2008	2007	2006
REVENUES:			
Product revenue, net	\$ 330,532	\$ 339,500	\$ 333,311
Service fee revenue	85,406	74,480	67,056
Pass-through revenue	35,905	32,822	22,886
Total revenues	451,843	446,802	423,253
COSTS OF REVENUES:			
Cost of product revenue	305,090	313,835	311,417
Cost of service fee revenue	58,009	53,375	49,274
Cost of pass-through revenue	35,905	32,822	22,886
Total costs of revenues	399,004	400,032	383,577
Gross profit	52,839	46,770	39,676
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, including stock based compensation expense of \$547, \$764, and \$899 in the years ended December 31, 2008, 2007 and 2006, respectively	49,073	44,057	45,189
MERGER INTEGRATION EXPENSES		150	1,495
AMORTIZATION OF IDENTIFIABLE INTANGIBLES	806	806	749
GOODWILL AND INTANGIBLE ASSET IMPAIRMENT	16,250		3,507
Total operating expenses	66,129	45,013	50,940
Income (loss) from operations	(13,290)	1,757	(11,264)
INTEREST EXPENSE	1,623	2,505	2,171
INTEREST INCOME	(63)	(163)	(59)
Loss before income taxes	(14,850)	(585)	(13,376)
INCOME TAX EXPENSE	805	799	1,154
NET LOSS	\$ (15,655)	\$ (1,384)	\$ (14,530)
LOSS PER SHARE:			
Basic and Diluted	\$ (1.58)	\$ (0.14)	\$ (1.60)

WEIGHTED AVERAGE NUMBER OF SHARES
OUTSTANDING:

Basic and Diluted	9,905	9,889	9,098
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The accompanying notes are an integral part of these consolidated financial statements.

PFSWEB, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND
COMPREHENSIVE LOSS

(In thousands, except share data)

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock Shares	Treasury Stock Amount	Total Shareholders' Equity	Comprehensive Income (Loss)
	Shares	Amount	Capital	Deficit	(Loss)	Shares	Amount	Equity	(Loss)
Balance, December 31, 2005	4,811,343	\$ 5	\$ 58,754	\$ (29,824)	\$ 1,084	18,361	\$ (85)	\$ 29,934	
Net loss				(14,530)				(14,530)	\$ (14,530)
Stock-based compensation expense			899					899	
Employee stock purchase plan	11,581		52					52	
Proceeds from exercised options	5,931		16					16	
Issuance of common stock	1,063,830	1	4,843					4,844	
Shares issued for eCOST acquisition	4,012,368	4	26,775					26,779	
Other comprehensive income foreign currency translation adjustment					846			846	846
Comprehensive loss									\$ (13,684)
Balance, December 31, 2006	9,905,053	\$ 10	\$ 91,339	\$ (44,354)	\$ 1,930	18,361	\$ (85)	\$ 48,840	
Net loss				(1,384)				(1,384)	\$ (1,384)
Stock-based compensation expense			764					764	
Employee stock purchase plan	3,852		18					18	
Proceeds from exercised	496								

[illegible]

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)

	2008	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	\$ (15,655)	\$ (1,384)	\$ (14,530)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	6,622	8,180	7,476
Goodwill and intangible asset impairment	16,250		3,507
Loss on sale of assets	17		144
Provision for doubtful accounts	174	254	960
Provision for excess and obsolete inventory	1,482	665	1,495
Deferred income taxes	(293)	84	(148)
Stock-based compensation expense	547	764	899
Changes in operating assets and liabilities:			
Restricted cash	291	(299)	845
Accounts receivables	3,020	2,104	1,673
Inventories, net	(3,243)	2,261	2,856
Prepaid expenses, other receivables and other assets	(5,031)	2,137	(66)
Accounts payable, accrued expenses and other liabilities	5,270	(9,367)	(2,627)
Net cash provided by operating activities	9,451	5,399	2,484
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(5,754)	(3,862)	(3,978)
Proceeds from sale of assets	117		
Payment for purchase of eCOST, net of cash acquired			(1,299)
Decrease in restricted cash		145	893
Net cash used in investing activities	(5,637)	(3,717)	(4,384)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from issuance of common stock	60	19	4,912
Decrease (increase) in restricted cash	(278)	785	(1,109)
Payments on capital lease obligations	(1,791)	(2,225)	(1,504)
Proceeds from (payments on) from debt, net	(41)	(1,669)	1,029
Net cash provided by (used in) financing activities	(2,050)	(3,090)	3,328
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	14	614	(45)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,778	(794)	1,383
CASH AND CASH EQUIVALENTS, beginning of period	14,272	15,066	13,683
CASH AND CASH EQUIVALENTS, end of period	\$ 16,050	\$ 14,272	\$ 15,066
SUPPLEMENTAL CASH FLOW INFORMATION			
Non-cash investing and financing activities:			
Property and equipment acquired under capital leases	\$ 584	\$ 3,016	\$ 2,304
Shares issued to acquire eCOST	\$	\$	\$ 26,778

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

PFSWEB, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Overview

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

PFSweb Overview

PFSweb is an international provider of integrated eCommerce and 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 InfoPrint Solutions Company (IPS), a joint venture company owned by Ricoh and International Business Machines Corporation (IBM), have entered into master distributor agreements under which Supplies Distributors acts as a master distributor of various products, primarily IPS product.

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 IPS products. Pursuant to the transaction management services agreements between PFSweb and Supplies Distributors, PFSweb provides to Supplies Distributors transaction management and fulfillment services, such 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. Supplies Distributors does not have its own sales force and relies upon IPS's sales force and product demand generation activities for its sale of IPS products. 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 IPS. Although management believes that the terms of these agreements are generally 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.

eCOST Overview

eCOST is a multi-category online discount retailer of new, close-out and recertified brand-name merchandise, selling products primarily to customers in the United States. eCOST offers products in several merchandise categories, including computers, networking, electronics and entertainment, TV's, plasmas and monitors, cameras and camcorders, memory and storage, For the Home and sports and leisure. eCOST carries products from leading manufacturers such as Sony, JVC, Canon, Hewlett-Packard, Denon, Dyson, Sennheiser, Garmin, Panasonic, Toshiba and Microsoft.

The Company's liquidity has been negatively impacted as a result of the merger with eCOST. Since the merger, eCOST has experienced a net use of cash primarily due to operating losses. As a result, the Company has had to support eCOST's cash needs with the goal of reducing losses. The amount of additional cash needed to support eCOST operations will depend upon the working capital requirements, bank financing availability as well as eCOST's continued ability to improve its financial results. Further advances to eCOST may be limited by the Company's current cash and future cash flow and may be restricted by the Company's credit facility obligations.

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

In the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company's financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

Management currently believes eCOST will meet the Company's expectations related to improved overall profitability. The Company has reported improvement in eCOST's financial results during 2007 and 2008, excluding the impact of any non-cash impairment charges, and currently expects continued improvement as a result of efforts to increase sales, improve product mix and control operating costs, although there can be no assurance that these future improvements will be achieved. If eCOST does not meet expectations, the Company currently anticipates that it would be able to terminate or sublease eCOST's facilities, liquidate remaining inventory through the eCOST website and reduce certain personnel related costs as needed so as to minimize any material impact upon the Company's other segments.

Acquisition of eCOST

Effective February 1, 2006, a wholly-owned subsidiary of PFSweb merged with and into eCOST, with eCOST surviving the merger as a wholly-owned subsidiary of PFSweb. Each of the issued and outstanding shares of common stock of eCOST were converted into one share of common stock of the Company. In conjunction with the merger, the Company assumed certain warrants previously issued to a former eCOST warrant-holder, subject to the terms set forth therein, which expired unexercised during 2008. As a result of the merger, effective February 1, 2006, the Company began consolidating 100% of eCOST's financial position and results of operations into the Company's consolidated financial statements. The following table presents selected pro forma information, for comparative purposes, assuming the acquisition had occurred on January 1 for the period presented (unaudited) (in thousands, except per share data):

	Year Ended 2006
Net revenues	\$436,187
Net loss	(16,120)
Basic and diluted loss per share	(1.77)

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

The transaction was accounted for using the purchase method of accounting for business combinations and, accordingly, the results of operations of eCOST have been included in the Company's consolidated financial statements since the date of acquisition. For purposes of computing the purchase price, the value of the 4.0 million shares of the Company's common stock issued was \$6.67 per common share, based on the average closing price of the Company's common stock on NASDAQ for the period beginning two days prior to the consummation of the merger and ending on the consummation of the merger.

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

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed as of February 1, 2006 (in thousands):

Cash and restricted cash	\$ 1,053
Accounts receivable, net	5,723
Inventories	6,893
Identifiable intangibles	7,380
Property and equipment	479
Other assets	323
 Total identifiable assets acquired	 21,851
 Trade accounts payable	 8,248
Accrued expenses	3,560
Other liabilities	834
 Total liabilities assumed	 12,642
 Net identifiable assets acquired	 9,209
Estimated purchase price	28,078
 Goodwill acquired	 \$ 18,869

Purchase price for eCOST is as follows (in thousands):

Number of shares of common stock issued	4,012
Multiplied by the Company's stock price	\$ 6.67
 Share consideration	 \$ 26,778
Transaction costs	1,300
 Purchase price	 \$ 28,078

The above purchase price was allocated based on estimates of the fair values of assets acquired and liabilities assumed.

The Company acquired eCOST because of the strategic benefits expected to result from combining eCOST's e-commerce platform with PFSweb's advanced technology and operational infrastructure thereby providing the combined company with the enhanced ability to expand its market share in the fast growing web commerce market. Such benefits are the primary factors that contributed to a purchase price that resulted in the recognition of goodwill.

The excess of the purchase price over the fair value of the net identifiable assets acquired and liabilities assumed was allocated to goodwill and is included in the eCOST reportable segment. Goodwill, which is not deductible for tax purposes, is not being amortized but is subject to an impairment test each year, using a fair-value-based approach pursuant to SFAS No. 142.

During the Company's annual analysis of the carrying value of goodwill, the Company determined the carrying value of goodwill exceeded its fair value, which resulted in a non-cash write-off of goodwill of \$11.8 million and \$3.5 million during 2008 and 2006, respectively. The Company performs its annual goodwill impairment test as of December 31. As a result of the decline in stock price, the market capitalization plus an implied control premium fell

significantly below the recorded value of its consolidated net assets as of the testing date. In performing the goodwill impairment test, the Company used current market capitalization, control premiums, discounted cash flows and other factors as the best evidence of fair value.

In connection with the goodwill impairment test, the Company determined that certain of its identifiable acquired intangible assets were impaired. The determination was based on the carrying values exceeding the future undiscounted cash flows and fair value attributable to such intangible assets. As a result, the Company recorded a non-cash impairment charge of \$4.5 million during 2008, which represents the difference between the estimated fair values of these long-lived assets and their carrying values. Fair values were determined based upon market conditions, the relief from royalty approach which utilized cash flow projections, and other factors.

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

There are no residual values for any of the intangible assets subject to amortization acquired during the eCOST acquisition. The Company is amortizing the intangible assets acquired on a straight-line basis over their estimated remaining useful lives. Definite lived intangible assets acquired in the eCOST acquisition consist of (in thousands):

	December 31, 2008			December 31, 2007		
	Fair Value			Net		Net
	at	Accumulated	Impairment	Carrying	Accumulated	Carrying
	Acquisition	Amortization	Charge	Value	Amortization	Value
Trademark name	\$ 4,635	\$ (1,352)	\$ (2,756)	\$ 527	\$ (888)	\$ 3,747
Customer relationships	2,745	(1,011)	(1,734)		(668)	2,077
Total definite lived intangible assets	\$ 7,380	\$ (2,363)	\$ (4,490)	\$ 527	\$ (1,556)	\$ 5,824

The estimated useful lives of the trademark name and customer relationships were originally 10 years and 8 years, respectively, but have since been reduced to 5 and 0 years, respectively, remaining as of December 31, 2008.

Amortization expense for intangible assets was \$0.8 million for the years ended December 31, 2008 and 2007 and \$0.7 million in 2006. Subsequent to the 2008 impairment charge, amortization expense for intangible assets is estimated to be approximately \$0.1 million annually for each year through the period ending December 31, 2013.

The Company incurred costs for operational integration and IT systems conversion activities related to the acquisition of \$0.2 million and \$1.5 million in the years ended December 31, 2007 and 2006, respectively. The Company incurred no such expenses in 2008.

2. Significant Accounting Policies

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Investment in Affiliates

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has made advances to Supplies Distributors that are evidenced by 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 \$6.5 million or decreased to lower than \$5.0 million without prior approval of the Company's lenders (see Notes 3 and 4). As of December 31, 2008 and 2007, the outstanding balance of the Subordinated Note was \$5.5 million and \$6.0 million, respectively. The Subordinate Note is eliminated in the Company's consolidated financial statements.

PFS has also made advances to eCOST, which aggregated \$10.6 million and \$7.9 million as of December 31, 2008 and 2007, respectively. Certain terms of the Company's debt facilities, provide that the total advances to eCOST may not be less than \$2.0 million without prior approval of eCOST's lender. PFS has received the approval of its lender to advance \$0.5 million plus incremental amounts subject to certain cash inflows to PFS, as defined, to certain of its subsidiaries and/or affiliates, including eCOST, if needed. PFSweb has also advanced eCOST \$4.7 million as of December 31, 2008 and 2007.

Use of Estimates

The preparation of consolidated financial statements and related disclosures in conformity with generally accepted accounting principles requires management to make judgments, 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 revenues and 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.

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

Revenue and Cost Recognition

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

Freight costs billed to customers are reflected as components of product revenue. Freight costs incurred are recorded as a component of cost of goods sold.

Under the master distributor agreements (see Note 6), Supplies Distributors bills IPS 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 IPS 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. Supplies Distributors records a receivable for these reimbursable amounts as they are incurred with a corresponding reduction in either inventory or cost of product revenue. Supplies Distributors also reflects pass through customer marketing programs as a reduction of product revenue and cost of product revenue.

eCOST recognizes product revenue, net of estimated returns, promotional discounts, credit card fraud and chargebacks, when both title and risk of loss to the products has transferred to the customer, which eCOST has determined to occur upon receipt of products by the customer. eCOST generally requires payment by credit card upon placing an order, and to a lesser extent, grants credit to business customers on normal credit terms. eCOST permits its customers to return defective product for credit against other purchases.

For product sales shipped directly from eCOST's vendors to end customers, eCOST records revenue and related costs at the gross amounts charged to the customer and paid to the vendor based on an evaluation of the criteria outlined in EITF No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*. eCOST's evaluation is performed based on a number factors, including whether eCOST is the primary obligor in the transaction, has latitude in establishing prices and selecting suppliers, takes title to the products sold upon shipment, bears credit risk, and bears inventory risk for returned products that are not successfully returned to third-party suppliers. eCOST recognizes revenue on extended warranties and other services for which it is not the primary obligor on a net basis.

The Company's service fee revenue primarily relates 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.

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

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 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 collectability is reasonably assured. Collectability 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. Related reserves are determined by either using percentages applied to certain aged receivable categories based on historical results and are reevaluated and adjusted as additional information is received or a specific identification method. After all attempts to collect a receivable have failed, the receivable is written off against the allowance for doubtful accounts.

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 that are included in property and equipment (in thousands):

	December 31, 2008	December 31, 2007
Deferred implementation revenues		
Current	\$ 2,556	\$ 772
Non-current	869	516
	\$ 3,425	\$ 1,288
Deferred implementation costs		
Current	\$ 956	\$ 388
Non-current	288	298
	\$ 1,244	\$ 686

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 service fee revenue is generated under contractual service fee relationships with multiple client relationships. No clients/customers exceeded 10% of consolidated revenue during the years ended 2008, 2007 or 2006. A summary of the customer and client concentrations is as follows:

	December 31, 2008	December 31, 2007	December 31, 2006
Product Revenue (as a percentage of Product Revenue):			
Customer 1	12%	10%	11%
Service Fee Revenue (as a percentage of Service Fee Revenue):			
Client 1	37%	27%	23%
Client 2	10%	11%	12%
Client 3	6%	12%	19%
Accounts Receivable:			
Customer 1	11%	10%	13%

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

Client 1 has advised PFS that it is not renewing its contract with PFS effective January 2009, though certain project work is anticipated to occur during the first half of 2009.

PFSweb has provided certain collateralized guarantees of its subsidiaries' financings and credit arrangements. These subsidiaries' ability to obtain financing on similar terms would be significantly impacted without these guarantees.

The Company has multiple arrangements with IBM and IPS and is dependent upon the continuation of such arrangements. Substantially all of the Supplies Distributors' revenue is generated by its sale of product purchased from IPS. 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 and IPS business units and an IBM term master lease agreement. Supplies Distributors also relies upon IPS's sales force and product demand generation activities and the discontinuance of such services would have a material impact upon Supplies Distributors' business.

eCOST's arrangements with its vendors are terminable by either party at will. Loss of any vendors could have a material adverse effect on eCOST's financial position, results of operations and cash flows. Sales of HP and HP-related products represented 43% of eCOST's net revenues in 2008 (9% of consolidated net revenues), 49% of eCOST's net revenues in 2007 (11% of consolidated net revenues) and 33% of eCOST's net revenues in 2006 (7% of consolidated net revenues).

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash includes the following items (in thousands):

	December 31, 2008	December 31, 2007
Customer remittances	\$ 458	\$ 1,971
Bond financing (see note 4)	1,550	50
Total restricted cash	\$ 2,008	\$ 2,021

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, 2008 and 2007, these bank accounts held \$0.2 million and \$1.5 million, respectively, which was restricted and can only be used to reduce the outstanding debt.

In conjunction with certain of its financing agreements, eCOST has granted to its lender a security interest in certain customer remittances received in specified bank accounts (see Note 4). At December 31, 2008 and 2007 these bank accounts held \$0.2 million and \$0.5 million, respectively, which was restricted and can only be used to reduce the outstanding debt.

Other Receivables

Other receivables include \$9.6 million and \$10.0 million as of December 31, 2008 and 2007, respectively, primarily for amounts due from IPS and IBM for costs incurred by the Company under the master distributor agreements (see Note 6). In addition, other receivables included \$3.5 million, and \$0.2 million as of December 31, 2008 and 2007, respectively, applicable to value added tax receivables.

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. The Company establishes inventory reserves based upon estimates of declines in values due to inventories that are slow moving or obsolete, excess levels of inventory or values assessed at lower than cost.

Supplies Distributors assumes responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined (see Note 6). In the event PFSweb, Supplies Distributors and IPS terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors then existing inventory.

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

eCOST inventories include goods in-transit to customers.

The 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 \$2.1 million as of December 31, 2008 and 2007.

Property and Equipment

The components of property and equipment as of December 31, 2008 and 2007 are as follows (in thousands):

	December 31, 2008	December 31, 2007	Depreciable Life
Furniture and fixtures	\$ 19,126	\$ 22,510	2-10 years
Purchased and capitalized software costs	17,490	14,595	3-5 years
Computer equipment	10,774	10,442	3-5 years
Leasehold improvements	7,628	7,779	3-7 years
Other	571	101	3-5 years
	55,589	55,427	
Less-accumulated depreciation and Amortization	(43,483)	(43,509)	
Property and equipment, net	\$ 12,106	\$ 11,918	

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

The Company's property held under capital leases amount to approximately \$3.4 million and \$4.6 million, net of accumulated amortization, of approximately \$8.4 million and \$10.5 million, at December 31, 2008 and 2007, respectively.

Long-Lived Assets

The Company reviews long-lived assets for impairment periodically, but at a minimum annually, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets include property, intangible assets, goodwill and certain other assets. Recoverability of assets 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. The Company makes judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and

PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

amortization methods and useful lives. The Company records impairment losses in the period in which it determines that the carrying amount is not recoverable. This may require the Company to make judgments regarding long-term forecasts of their future revenues and costs related to the assets subject to review. During the fourth quarter of 2008, the Company recorded an impairment charge of \$11.8 million against goodwill and a \$4.5 million impairment charge against intangible assets (discussed in Note 1). An impairment charge of \$3.5 million was recorded against goodwill in 2006.

Foreign Currency Translation and Transactions

For the Company's Canadian and European operations, the local currency is the functional currency. All assets 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 and loss. Currency gains and losses, including transaction gains and losses and those on short-term intercompany advances, included in net loss were net gains of approximately \$0.1 million, \$1.0 million and \$0.3 million for the years ended December 31, 2008, 2007 and 2006, respectively. The Company reports gains and losses on intercompany foreign currency transactions that are of a long-term investment nature as a separate component of shareholders' equity.

Impact of Recently Issued Accounting Standards

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis, at least annually, until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and the Company adopted SFAS 157 for financial assets and liabilities on January 1, 2008, with no material impact to its consolidated financial statements. The Company adopted fair value measurement treatment for nonfinancial assets and liabilities on January 1, 2009, which did not have a material impact.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option For Financial Assets and Financial Liabilities*. This new standard allows companies to elect to measure specified financial instruments and warranty and insurance contracts at fair value on a contract-by-contract basis, with changes in fair value recognized in earnings in each reporting period. The Company did not elect the fair value option under this Statement.

In December 2007, the FASB issued Statement No. 141R, *Business Combinations*, and Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. Statement No. 141R modified the accounting and disclosure requirements for business combinations and broadens the scope of the previous standard to apply to all transactions in which one entity obtains control over another business. Statement No. 160 establishes new accounting and reporting standards for noncontrolling interests in subsidiaries. The Company will be required to apply the provisions of the new standards in the first quarter of 2009. The impact of this statement on the Company's financial statements is expected to be immaterial.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110 (SAB 110). SAB 110 permits companies to continue to use the simplified method, under certain circumstances, in estimating the expected term of plain vanilla options beyond December 31, 2007. SAB 110 updates guidance provided in SAB 107 that previously stated that the Staff would not expect a company to use the simplified method for share option grants after December 31, 2007. The Company will continue to use the simplified method until it has sufficient historical exercise data to provide a reasonable basis upon which to estimate the expected term of its options.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP No. 142-3). This guidance is intended to improve the consistency between the useful life of a recognized intangible

PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142), and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) when the underlying arrangement includes renewal or extension of terms that would require substantial costs or result in a material modification to the asset upon renewal or extension. Companies estimating the useful life of a recognized intangible asset must now consider their historical experience in renewing or extending similar arrangements or, in the absence of historical experience, must consider assumptions that market participants would use about renewal or extension as adjusted for SFAS No. 142's entity-specific factors. FSP No 142-3 is effective beginning January 1, 2009 and will be applied prospectively to intangible assets acquired after the effective date. The Company is currently assessing the impact this adoption will have on its consolidated financial statements.

Income Taxes

The Company adopted the provisions of FIN 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007 with no impact on the financial statements. The Company recognizes interest and penalties related to certain tax positions in income tax expense.

For federal income tax purposes, tax years that remain subject to examination include years 2004 through 2008. However, the utilization of net operating loss (NOL) carryforwards that arose prior to 2004 remain subject to examination through the years such carryforwards are utilized. For Europe, tax years that remain subject to examination include years 2005 to 2008. However, the utilization of NOL carryforwards that arose prior to 2005 remain subject to examination through the years such carryforwards are utilized. For Canada, tax years that remain subject to examination include years 2001 to 2008, depending on the subsidiary. For state income tax purposes, the tax years that remain subject to examination include years 2003 to 2008, depending upon the jurisdiction in which the Company files tax returns.

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 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 Loss Per Common Share

Basic and diluted net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding for the reporting period. Stock options not included in the calculation of diluted net loss per share for the years ended December 31, 2008, 2007 and 2006, were 1.4 million, 1.3 million, and 1.3 million,

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

respectively, as the effect would be anti-dilutive. Warrants not included in the calculation of diluted net loss per share for the years ended December 31, 2007 and 2006, were 0.1 million, at each date, as the effect would be anti-dilutive.

Cash Paid For Interest and Taxes During Year

The Company made payments for interest of approximately \$1.7 million, \$2.6 million and \$2.8 million and income taxes of approximately \$1.6 million, \$1.5 million and \$0.5 million during the years ended December 31, 2008, 2007, and 2006, respectively (see Notes 3, 4 and 8).

Advertising Costs

Advertising expenses for eCOST, including those for catalog, internet and other methods, were \$0.9 million, \$1.1 million and \$2.7 million for the years end December 31, 2008, 2007 and 2006, respectively and are included in selling, general and administrative expenses. There were no such expenses to the Company prior to the acquisition of eCOST.

Reverse Stock Split

On June 2, 2008, the Company effected a 1-for-4.7 reverse split (Reverse Split) of the Company's common stock. Pursuant to the Reverse Split, the common stock was combined and reclassified based on a ratio of 4.7 shares of issued and outstanding common stock being combined and reclassified into one share of common stock. All share and per share amounts for common stock, warrants and stock options have been restated to reflect the Reverse Split on a retro-active basis.

3. Vendor Financing

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

	December 31, 2008	December 31, 2007
Inventory and working capital financing agreements:		
United States	\$ 23,885	\$ 23,667
Europe	16,422	13,340
Total	\$ 40,307	\$ 37,007

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 IPS products in the United States, providing financing for eligible IPS inventory and for certain receivables up to \$30.5 million through its expiration in March 2009. As of December 31, 2008, 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 (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$5.5 million and a minimum shareholders' equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (3.75% and 7.75% as of December 31, 2008 and 2007, respectively). The facility also includes a monthly service fee.

On March 27, 2009, Supplies Distributors entered into an amended credit facility with IBM Credit LLC, which extends the termination date through March 2010 and reduces the minimum Subordinated Note balance to \$5.0 million. Given the structure of this facility and as outstanding balances, which represent inventory purchases, are repaid within twelve months, the Company has classified the outstanding amounts under this facility as accounts

payable in the consolidated balance sheets.

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)*****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 IPS products in Europe. The asset based credit facility with IBM Belgium provides up to 16.0 million Euros (approximately \$22.3 million at December 31, 2008) in financing for purchasing IPS inventory and for certain receivables through its expiration in March 2009. As of December 31, 2008, Supplies Distributors European subsidiaries had 4.0 million Euros (approximately \$5.6 million at December 31, 2008) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiaries to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors European subsidiaries, as well as collateralized guaranties of Supplies Distributors and PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$5.5 million and a minimum shareholders equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at Euribor plus 1.5% as of December 31, 2008 and 2007 (4.1% and 5.8% as of December 31, 2008 and 2007, respectively). Supplies Distributors European subsidiaries pay a monthly service fee on the commitment.

On March 30, 2009, Supplies Distributors European subsidiaries entered into an amended credit facility with IBM Belgium, which extends the termination date through March 2010, reduces the minimum Subordinated Note balance to \$5.0 million and increases the interest rate to Euribor plus 1.94% or Euribor plus 4.25%, depending on the type of borrowing utilized. Given the structure of this facility and as outstanding balances, which represent inventory purchase, are repaid within twelve months, 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, 2008	December 31, 2007
Loan and security agreements, United States:		
Supplies Distributors	\$ 9,649	\$ 10,353
PFS	6,000	7,225
Credit facility eCOST		
Factoring agreement, Europe	2,577	1,212
Taxable revenue bonds	3,200	4,000
Master lease agreements	4,657	5,033
Other	1,119	793
Total	27,202	28,616
Less current portion of long-term debt	22,251	22,238
Long-term debt, less current portion	\$ 4,951	\$ 6,378

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Wachovia Bank, N.A. (Wachovia) to provide financing for up to \$25 million of eligible accounts receivable in the United States and Canada. As of December 31,

2008, Supplies Distributors had \$1.7 million of available credit under this agreement. The Wachovia facility expires on the earlier of March 2009 or the date on which the parties to the IPS master distributor agreement (see Note 6) no longer operate under the terms of such agreement and/or IPS no longer supplies products pursuant to such agreement. Borrowings under the Wachovia facility accrue interest at prime rate or Eurodollar rate plus 1.75% to

PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

2.25%, dependent on excess availability, as defined. The interest rate as of December 31, 2008 was 4.0% for \$5.6 million of outstanding borrowings and 2.5% for \$4.0 million of outstanding borrowings. As of December 31, 2007, the interest rate was 7.25% for \$6.4 million of outstanding borrowings and 7.2% 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 entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than \$5.5 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 Wachovia pursuant to which a security interest was granted to Wachovia for all U.S. and Canadian customer remittances received in specified bank accounts. At December 31, 2008 and December 31, 2007, these bank accounts held \$0.1 million and \$1.4 million, respectively, which was restricted for payment to Wachovia.

On January 6, 2009, Supplies Distributors entered into an amended loan and security agreement with Wachovia, which extends the termination date through March 2011, reduces the minimum Subordinate Note balance to \$5.0 million and amends the interest rate to prime rate plus 0.25% to 0.75% or Eurodollar rate plus 2.5% to 3.0%.

Loan and Security Agreement PFSweb

PFS has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to \$10.0 million of eligible accounts receivable financing through April 2009. As of December 31, 2008, PFS had \$3.8 million of available credit under this facility. This agreement accrues interest at prime rate plus 1% (4.25% and 8.25% as of December 31, 2008 and 2007, respectively). The Comerica Agreement contains cross default provisions, various restrictions upon PFS ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including entities directly or indirectly owned by PFSweb, Inc.), make capital expenditures, 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 receivable from Supplies Distributors to a maximum of \$6.5 million. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb, Inc.

On March 31, 2009, PFS entered into an amended agreement with Comerica, which extends the termination date through March 2010, modifies certain financial covenants, increases the interest rate and provides the approval for PFS to advance incremental amounts subject to certain cash inflows to PFS, as defined, to certain of its subsidiaries and/or affiliates, including eCOST, with certain restrictions, if needed.

Credit Facility eCOST

eCOST has an asset-based line of credit facility that provides for borrowings of up to \$7.5 million from Wachovia, through May 2009, which is collateralized by substantially all of eCOST's assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory. Outstanding amounts under the facility bear interest at rates ranging from prime rate to the prime rate plus 0.5% (3.25% and 7.75% as of December 31, 2008 and 2007, respectively, depending on eCOST's financial results. As of December 31, 2008, eCOST had \$1.1 million of letters of credit outstanding and \$2.0 million of available credit under this facility. In connection with the line of credit, eCOST entered into a cash management arrangement whereby eCOST's operating amounts are swept and used to repay outstanding amounts under the line of credit. The credit facility restricts eCOST's ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth of

\$0, as defined. PFSweb has guaranteed all current and future obligations of eCOST under this line of credit.

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PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

On January 6, 2009, eCOST entered into an amended loan and security agreement with Wachovia, which extends the termination date through May 2011, and amends the interest rate to prime rate plus 0.75% to 1.25% or Eurodollar rate plus 3.0% to 4.0%.

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 \$10.4 million at December 31, 2008) of eligible accounts receivables through March 2010. As of December 31, 2008, Supplies Distributors European subsidiary had approximately 0.7 million Euros (\$1.0 million) of available credit under this agreement. Borrowings accrue interest at Euribor plus 0.9% (3.5% and 4.9% at December 31, 2008 and 2007, respectively). 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

PFS 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 PFS 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 (2.9% as of December 31, 2008), as determined by Comerica Securities, as Remarketing Agent. PFS, 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 PFS and Comerica under which PFS is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of April 2010 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof. If the Letter of Credit is renewed or replaced, the Bonds require future principal repayments of \$800,000 in January of each year through 2012. PFS' obligations under the Reimbursement Agreement are secured by substantially all of the assets of PFS, including restricted cash of \$1.5 million and a Company parent guarantee.

Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with its covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of shareholders' equity or net worth, and one or all of the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. In particular, in the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company's financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of three years. The amounts outstanding under this Master Lease Agreement were \$1.7 million and \$1.2 million as of December 31, 2008 and 2007, respectively, which are secured by the related equipment (see Note 2).

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

The Company has two other master agreements with financing companies that provide for leasing or financing transactions of certain equipment. The amounts outstanding under these agreements as of December 31, 2008 and 2007 were \$1.5 million and \$2.0 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, 2008 are as follows (in thousands):

Fiscal year ended December 31,	
2009	\$ 20,486
2010	2,806
2011	339
2012	198
2013	156
Thereafter	
Total	\$ 23,985

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, 2008 (in thousands):

Fiscal year ended December 31,	
2009	\$ 1,969
2010	1,062
2011	414
2012	82
Thereafter	
Total minimum lease payments	\$ 3,527
Less amount representing interest at rates ranging from 4.5% to 16.5%	(310)
Present value of net minimum lease payments	3,217
Less: Current portion	(1,765)
Long-term capital lease obligations	\$ 1,452

5. Stock and Stock Options

On June 2, 2008, the Company effected a 1-for-4.7 reverse split (Reverse Split) of the Company's common stock. Pursuant to the Reverse Split, the common stock was combined and reclassified based on a ratio of 4.7 shares of issued and outstanding common stock being combined and reclassified into one share of common stock. No fractional shares were issued in connection with the Reverse Split. Shareholders who were entitled to fractional shares received cash in lieu of fractional shares. All share, per share, warrant and option amounts have been restated to reflect the Reverse Split on a retro-active basis.

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 \$314.90, 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 20 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.

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

Employee Stock Purchase Plan

The Company offers 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 permits each U.S. employee who has completed 90 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. The Stock Purchase Plan provides for acquisition of the Company's common stock at a 5% discount to the market value on the date of purchase. The Company has reserved 0.9 million shares of its common stock under the Stock Purchase Plan. During the years ended December 31, 2008, 2007 and 2006, the Company issued 7,522, 3,852 and 11,581 shares under the Stock Purchase Plan, respectively. As of December 31, 2008, there were 450,641 shares available for further issuance under the Stock Purchase Plan.

Private Placement Transactions

In 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 its common stock, par value \$.001 per share (the "Common Stock"). In addition to the Common Stock, the investors received four-year warrants to purchase an aggregate 84,145 shares of Common Stock at an exercise price of \$15.51 per share. As a result of the merger with eCOST and the private placement transaction in June 2006, the warrants were adjusted such that there were 120,208 warrants outstanding with an exercise price of \$10.86 per share as of December 31, 2007. These warrants expired unexercised in January 2008.

In June 2006, the Company entered into a Purchase Agreement and Registration Rights Agreement with certain institutional investors in a private placement transaction pursuant to which the Company issued and sold an aggregate of 1,063,830 shares of its common stock, par value \$.001 per share, at \$4.70 per share, resulting in gross proceeds of \$5.0 million. After deducting expenses, the net proceeds were approximately \$4.8 million. The Company has advanced \$4.7 million of these proceeds to eCOST as of December 31, 2008.

Stock Options and Stock Option Plans

On January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment*, (FAS 123R). The Company adopted FAS 123R using the modified prospective transition method. Under that transition method, compensation cost recognized during the years ended December 31, 2008, 2007 and 2006 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of FAS 123R. Compensation cost is recognized on a straight-line basis, net of estimated forfeitures, over the requisite service period of each award.

Stock-based compensation charged against income was \$0.5 million, \$0.8 million and \$0.9 million for the years ended December 31, 2008, 2007 and 2006, respectively. As of December 31, 2008, there was \$0.5 million of total unrecognized compensation costs related to unvested stock options, which is expected to be recognized over a weighted average period of approximately 1.9 years.

As of December 31, 2008, the Company had the following share-based compensation plans:

PFSweb Plan Options

The Company has an Employee Stock and Incentive Plan and an Outside Director Stock Option and Retainer Plan under which an aggregate of 1,808,510 shares of common stock were originally authorized for issuance (the "Stock Options Plans") and an outstanding stock option agreement under which 7,446 shares were originally authorized for issuance. The Stock Option Plans provide for the granting of incentive awards in the form of stock options to directors, executive management, key employees, and outside consultants of the Company. The rights to purchase shares under the employee stock option agreements typically vest over a three-year period, one-twelfth

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

each quarter. Stock options must be exercised within 10 years from the date of grant. Stock options are generally issued such that the exercise price is equal to the market value of the Company's common stock at the date of grant.

As of December 31, 2008, there were 366,816 shares available for future grants under the Stock Option Plans.

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

			Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
	Shares	Price Per Share			
Outstanding, December 31, 2007	1,208,659	\$ 1.83-\$75.20	\$5.88		
Granted	182,554	\$ 4.04-\$5.55	\$4.35		
Exercised	(18,173)	\$ 1.83-\$3.43	\$1.84		
Canceled	(20,633)	\$ 1.83-\$12.08	\$6.33		
Outstanding, December 31, 2008	1,352,407	\$ 1.83-\$75.20	\$5.71		
Exercisable, December 31, 2008	1,148,770	\$ 1.83-\$75.20	\$5.94	4.4	\$
Exercisable and expected to vest, December 31, 2008	1,312,313	\$ 1.83-\$75.20	\$5.74	4.4	\$

The weighted average fair value per share of options granted during the years ended December 31, 2008, 2007 and 2006 was \$3.14, \$3.34 and \$5.31, respectively. The total intrinsic value of options exercised under the Stock Option Plans was \$0.04 million and \$0.02 million during the years ended December 31, 2008 and 2006, respectively.

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.

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

Weighted Average Exercise	Weighted Average Remaining Contractual	Aggregate Intrinsic
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	Shares	Price Per Share	Price	Life	Value
Outstanding, December 31, 2007	91,323	\$4.28-\$49.73	\$ 4.42		
Granted		\$	\$		
Exercised		\$	\$		
Canceled	(301)	\$ 49.73	\$49.73		
Outstanding, December 31, 2008	91,022	\$ 4.28	\$ 4.28	2.9	\$
Exercisable, December 31, 2008	91,022	\$ 4.28	\$ 4.28	2.9	\$

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, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Expected dividend yield			
Expected stock price volatility	81% - 85%	87% - 90%	91% - 103%
Weighted average stock price volatility	84%	88%	102%
Risk-free interest rate	3.1% - 3.8%	4.4% - 5.0%	4.5% - 5.2%
Expected life of options (years)	6	6	0.5-6

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

6. Master Distributor Agreements

Supplies Distributors, PFSweb and IPS have entered into master distributor agreements under which Supplies Distributors acts as a master distributor of various products, primarily IPS product, and PFSweb provides transaction management and fulfillment services to Supplies Distributors. Under the master distributor agreements, IPS sells product to Supplies Distributors and reimburses Supplies Distributors for certain freight costs, direct costs incurred in passing on any price decreases offered by IPS 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 IPS product rendered obsolete by IPS engineering changes after customer demand ends. IPS determines when a product is obsolete. IPS and Supplies Distributors also have agreements under which IPS reimburses or collects from Supplies Distributors amounts calculated in certain inventory cost adjustments.

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

7. Supplies Distributors

Pursuant to a credit agreement, Supplies Distributors is restricted from making any distributions to PFSweb if, after giving affect thereto, Supplies Distributors would be in noncompliance with its financial covenants. Supplies Distributors has received lender approval to pay approximately \$2.4 million of dividends in 2009 but, under the terms of its amended credit agreements, is restricted from paying further annual cash dividends without the prior approval of its lenders (see Notes 3 and 4). Supplies Distributors paid dividends to PFSweb of \$3.0 million, \$2.4 million and \$3.9 million in the years ended December 31, 2008, 2007 and 2006, respectively.

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

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):

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Income tax benefit computed at statutory rate	\$ (5,049)	\$ (199)	\$ (4,548)
Impact of foreign taxation	(9)	(3)	(17)
Foreign dividends received	686	494	850
Items not deductible for tax purposes	4,382	230	1,704
Change in valuation reserve	(807)	898	3,285
Other	1,602	(621)	(120)
Provision for income taxes	\$ 805	\$ 799	\$ 1,154

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

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Domestic	\$ (18,178)	\$ (3,389)	\$ (15,035)
Foreign	3,328	2,804	1,659
Total	\$ (14,850)	\$ (585)	\$ (13,376)

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

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Current			
Domestic	\$ 70	\$ 57	\$ 105
State	195	(70)	419
Foreign	833	728	778
Total current	1,098	715	1,302
Deferred			
Domestic			
State		21	(59)
Foreign	(293)	63	(89)
Total deferred	(293)	84	(148)

Total	\$	805	\$	799	\$	1,154
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The components of the deferred tax asset (liability) are as follows (in thousands):

	December 31, 2008	December 31, 2007
Deferred tax assets:		
Allowance for doubtful accounts	\$ 390	\$ 551
Inventory reserve	762	747
Property and equipment	1,067	1,773
Net operating loss carryforwards	19,034	21,220
Other	1,458	1,123
	22,711	25,414
Less Valuation allowance	22,041	22,848
Total deferred tax asset	670	2,566
Deferred tax liabilities:		
Intangible assets	(179)	(1,980)
Other	(138)	(289)
Total deferred tax liabilities	(317)	(2,269)
Deferred tax assets, net	\$ 353	\$ 297

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

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 the majority of these net deferred income tax assets as of December 31, 2008 and 2007. At December 31, 2008, net operating loss carryforwards relate to taxable losses of PFSweb's European subsidiary totaling approximately \$8.2 million, PFSweb's Canadian subsidiary totaling approximately \$4.8 million and PFSweb's U.S. subsidiaries totaling approximately \$42.6 million that expire at various dates from 2009 through 2028. The U.S. NOL 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. The U.S. NOL also includes approximately \$21.0 million of NOL acquired through the acquisition of eCOST in February 2006, which is subject to annual limits under IRS Section 382.

9. Commitments and Contingencies

The Company leases facilities, warehouse, office, transportation and other equipment under operating leases expiring in various years through December 31, 2014. In most cases, management expects that, in the normal course of business, leases will be renewed or replaced by other leases. The Company's facility leases generally contain one or more renewal options. Minimum future annual rental payments under non-cancelable operating leases having original terms in excess of one year are as follows (in thousands):

	Operating Lease Payments
Fiscal year ended December 31,	
2009	\$ 8,343
2010	7,093
2011	3,581
2012	1,709
2013	1,061
Thereafter	177
Total	\$ 21,964

Minimum rental payments under operating leases are recognized on a straight-line basis over the term of the lease including any periods of free rent. Total rental expense under operating leases approximated \$10.8 million, \$10.3 million and \$8.7 million for the years ended December 31, 2008, 2007 and 2006, respectively. Certain landlord required deposits are secured by letters of credit.

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. In December 2006 the Company received notice that the municipal authority planned to make an adjustment to the Company's tax abatement. The Company has disputed the adjustment, but if the dispute is not resolved favorably, additional property taxes of approximately \$1.7 million could be assessed against the Company.

On July 25, 2007 a purported class action lawsuit entitled *Darral Frank and Joseph F. Keeley, Jr. v. PC Mall, Inc. dba eCOST.com and eCOST.com, Inc.* was filed in the Superior Court of California, Los Angeles County. The purported class consists of all of current and former sales representatives who worked for the defendants in California from July 24, 2003 through July 24, 2007. The lawsuit alleges that the defendants failed to pay overtime compensation and interest thereon, failed to timely pay compensation to terminated employees and failed to provide meal and rest periods, all in violation of the California Labor Code and Business and Professions Code. In December 2008, the matter was settled for \$0.1 million.

The Company is subject to claims in the ordinary course of business, including claims of alleged infringement by the Company or its subsidiaries of the patents, trademarks and other intellectual property rights of third parties. If the party asserting such claims commences litigation, the Company could be required to defend itself or its customers. The Company is not aware of any such litigation.

PFSWEB, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****10. Segment and Geographic Information**

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

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Revenues (in thousands):			
PFSweb	\$ 129,910	\$ 115,878	\$ 98,946
Supplies Distributors	230,710	235,357	244,979
eCOST	99,822	104,143	88,332
Eliminations	(8,599)	(8,576)	(9,004)
	\$ 451,843	\$ 446,802	\$ 423,253

Income (loss) from operations (in thousands):			
PFSweb	\$ (69)	\$ (1,421)	\$ (2,730)
Supplies Distributors	5,866	6,577	7,614
eCOST	(19,087)	(3,399)	(16,148)
Eliminations			
	\$ (13,290)	\$ 1,757	\$ (11,264)

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Depreciation and amortization (in thousands):			
PFSweb	\$ 5,607	\$ 7,149	\$ 6,420
Supplies Distributors	20	19	11
eCOST	995	1,012	1,045
Eliminations			
	\$ 6,622	\$ 8,180	\$ 7,476

Capital expenditures (in thousands):			
PFSweb	\$ 5,367	\$ 3,529	\$ 3,900
Supplies Distributors	87		49
eCOST	300	333	29
Eliminations			

\$ 5,754 \$ 3,862 \$ 3,978

	December 31, 2008	December 31, 2007
Assets (in thousands):		
PFSweb	\$ 108,436	\$ 102,950
Supplies Distributors	82,280	79,446
eCOST	13,489	33,615
Eliminations	(59,684)	(57,838)
	\$ 144,521	\$ 158,173

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

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, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Revenues (in thousands):			
United States	\$ 351,890	\$ 351,317	\$ 334,118
Europe	97,739	91,927	88,656
Canada	5,829	6,054	6,937
Inter-segment eliminations	(3,615)	(2,496)	(6,458)
	\$ 451,843	\$ 446,802	\$ 423,253
		December 31, 2008	December 31, 2007
Long-lived assets (in thousands):			
United States		\$ 16,805	\$ 32,800
Europe		892	1,160
Canada		160	55
		\$ 17,857	\$ 34,015

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. The Company contributed approximately \$0.2 million during the year ended December 31, 2008 and \$0.1 million during the years ended December 31, 2007 and 2006 to match 20% of employee contributions.

12. Quarterly Results of Operations (Unaudited)

Unaudited quarterly results of operations for years ended December 31, 2008 and 2007 were as follows (amounts in thousands, except per share data):

	Year Ended December 31, 2008			
	1 st Qtr.	2 nd Qtr.	3 rd Qtr.	4 th Qtr.
Total revenues	\$ 118,469	\$ 110,684	\$ 109,909	\$ 112,781
Total cost of revenues	105,189	97,855	96,568	99,392
Gross profit	13,280	12,829	13,341	13,389
Goodwill and intangible asset impairment				16,250
Operating expenses	12,296	12,050	12,656	12,877
Income (loss) from operations	984	779	685	(15,738)
Net income (loss)	414	62	43	(16,174)
Basic and diluted net income (loss) per share	0.04	0.01	0.00	(1.63)

	Year Ended December 31, 2007			
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Total revenues	\$ 104,407	\$ 108,400	\$ 111,995	\$ 122,000
Total cost of revenues	94,423	96,509	100,120	108,980
Gross profit	9,984	11,891	11,875	13,020
Operating expenses	11,555	10,819	10,882	11,757
Income (loss) from operations	(1,571)	1,072	993	1,263
Net income (loss)	(2,361)	154	162	661
Basic and diluted net income (loss) per share	(0.24)	0.02	0.02	0.06
	29			

PFSWEB, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

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 generally expected to be at its lowest in the quarter ended March 31 subject to transactional volumes of our clients. Supplies Distributors' product revenue business activity is expected to be at its highest in the quarter ended December 31. eCOST's business is moderately seasonal, reflecting the general pattern of peak sales for the retail industry during the holiday shopping season. Typically, a larger portion of eCOST's revenues occur during the fourth quarter.

Item 9a. (T) Controls And Procedures.

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 (the Exchange Act) Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the Evaluation Date), have concluded that as of the Evaluation Date, our disclosure controls and procedures are effective, in all material respects, to ensure that information required to be disclosed in the reports that we file and submit under the Exchange Act (i) is recorded, processed, summarized and reported as and when required and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There have been no significant changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) under the Exchange Act. Our internal control over financial reporting is designed, under the supervision of our chief executive and chief financial officers, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America (GAAP). Our internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that our receipts and expenditures are being made only in accordance with authorizations of our management and Board of Directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

We conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008. This evaluation was based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Also, projections of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our Chief Executive Officer and Chief Financial Officer concluded that internal control over financial reporting was effective as of December 31, 2008.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

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.

SCHEDULE I

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

	December 31, 2008	December 31, 2007
ASSETS:		
Cash and cash equivalents	\$ 926	\$ 175
Receivable from Priority Fulfillment Services, Inc.	5,624	5,602
Receivable from eCOST.com, Inc.	4,700	4,700
Investment in subsidiaries	22,609	38,365
 Total assets	 \$ 33,859	 \$ 48,842
 LIABILITIES:		
Payable to PFSweb BV SPRL	\$ 774	\$
 SHAREHOLDERS' EQUITY:		
Preferred stock		
Common stock	10	10
Additional paid-in capital	92,728	92,121
Accumulated deficit	(61,393)	(45,738)
Accumulated other comprehensive income	1,825	2,534
Treasury stock	(85)	(85)
 Total shareholders' equity	 33,085	 48,842
 Total liabilities and shareholders' equity	 \$ 33,859	 \$ 48,842

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)

	2008	2007	2006
EQUITY IN NET LOSS OF CONSOLIDATED SUBSIDIARIES	\$ (15,655)	\$ (1,384)	\$ (14,530)
NET LOSS	\$ (15,655)	\$ (1,384)	\$ (14,530)

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)

	2008	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	\$ (15,655)	\$ (1,384)	\$ (14,530)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Equity in net loss of consolidated subsidiaries	15,655	1,384	14,530
Net cash provided by operating activities			
 CASH FLOWS FROM INVESTING ACTIVITIES:			
Payment for purchase of eCOST.com, Inc., net of cash acquired			(1,299)
Net cash used in investing activities			(1,299)
 CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock	59	18	4,912
Increase in receivable from eCOST.com, Inc.			(4,700)
Increase in payable due to PFSweb BV SPRL	714		
Decrease (increase) in receivable from Priority Fulfillment Services, Inc., net	(22)	(124)	1,368
Net cash provided by (used in) financing activities	751	(106)	1,580
 NET INCREASE (DECREASE) IN CASH	 751	 (106)	 281
 CASH AND CASH EQUIVALENTS, beginning of period	 175	 281	
 CASH AND CASH EQUIVALENTS, end of period	 \$ 926	 \$ 175	 \$ 281

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	Charges	Additions	Balance		Balance
	Beginning	to Cost	Charges to	Acquired		at End
	of Period	and	Other	via	Deductions	of
		Expenses	Accounts	Acquisition		Period
Year Ended						
December 31, 2006:						
Allowance for doubtful accounts	\$ 484	960		1,072	(164)	\$ 2,352
Allowance for slow moving inventory	\$ 1,539	1,495			(47)	\$ 2,987
Income tax valuation allowance	\$12,422	3,285		6,243		\$21,950
Year Ended						
December 31, 2007:						
Allowance for doubtful accounts	\$ 2,352	254			(1,123)	\$ 1,483
Allowance for slow moving inventory	\$ 2,987	(440)			(467)	\$ 2,080
Income tax valuation allowance	\$21,950	898				\$22,848
Year Ended						
December 31, 2008:						
Allowance for doubtful accounts	\$ 1,483	174			(677)	\$ 980
Allowance for slow moving inventory	\$ 2,080	1,482			(1,438)	\$ 2,124
Income tax valuation allowance	\$22,848				(807)	\$22,041

SIGNATURES

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

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

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

Signature	Title	Date
/s/ MARK C. LAYTON Mark C. Layton	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	September 29, 2009
/s/ THOMAS J. MADDEN Thomas J. Madden	Executive Vice President and Chief Financial and Accounting Officer (Principal Financial and Accounting Officer)	September 29, 2009
/s/ DR. NEIL JACOBS Dr. Neil Jacobs	Director	September 29, 2009
/s/ TIMOTHY M. MURRAY Timothy M. Murray	Director	September 29, 2009
/s/ JAMES. F. REILLY James F. Reilly	Director	September 29, 2009
/s/ DAVID I. BEATSON David I. Beatson	Director	September 29, 2009