

OVERSTOCK.COM, INC
Form 10-Q
July 26, 2012
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

Or

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

For the transition period from to

Commission file number: 000-49799

OVERSTOCK.COM, INC.

Edgar Filing: OVERSTOCK.COM, INC - Form 10-Q

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

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

6350 South 3000 East

Salt Lake City, Utah 84121

(Address, including zip code, of Registrant's principal executive offices)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐
(Do not check if a smaller reporting company)

Smaller reporting company ☐

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

There were 23,447,391 shares of the Registrant's common stock, par value \$0.0001, outstanding on July 23, 2012.

Table of Contents

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 3. Defaults upon Senior Securities

Item 4. Mine Safety Disclosures

Item 5. Other Information

Item 6. Exhibits

Signature

[Table of Contents](#)**PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)****Overstock.com, Inc.****Consolidated Balance Sheets (Unaudited)****(in thousands)**

	June 30, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 59,998	\$ 96,985
Restricted cash	2,044	2,036
Accounts receivable, net	10,084	13,501
Inventories, net	21,074	22,993
Prepaid inventories, net	1,754	1,027
Prepays and other assets	15,097	12,651
Total current assets	110,051	149,193
Fixed assets, net	23,250	25,322
Goodwill	2,784	2,784
Other long-term assets, net	1,648	2,260
Total assets	\$ 137,733	\$ 179,559
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 40,625	\$ 70,332
Accrued liabilities	35,809	47,902
Deferred revenue	24,263	27,978
Line of credit	17,000	17,000
Capital lease obligations, current		110
Total current liabilities	117,697	163,322
Capital lease obligations, non-current		2
Other long-term liabilities	2,431	2,998
Total liabilities	120,128	166,322
Commitments and contingencies (Note 5)		
Stockholders equity:		
Preferred stock, \$0.0001 par value:		
Authorized shares - 5,000		
Issued and outstanding shares - none		
Common stock, \$0.0001 par value		
Authorized shares - 100,000		
Issued shares - 26,477 and 26,241		
Outstanding shares - 23,447 and 23,279	2	2
Additional paid-in capital	355,011	353,368
Accumulated deficit	(258,576)	(261,765)
Treasury stock:		
Shares at cost - 3,030 and 2,962	(78,832)	(78,368)

Edgar Filing: OVERSTOCK.COM, INC - Form 10-Q

Total stockholders' equity		17,605		13,237
Total liabilities and stockholders' equity	\$	137,733	\$	179,559

See accompanying notes to consolidated financial statements.

Table of Contents**Overstock.com, Inc.****Consolidated Statements of Operations and Comprehensive Income (Loss)****(Unaudited)****(in thousands, except per share data)**

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Revenue, net				
Direct	\$ 33,936	\$ 33,443	\$ 74,833	\$ 81,604
Fulfillment partner	205,600	201,549	427,070	418,858
Total net revenue	239,536	234,992	501,903	500,462
Cost of goods sold				
Direct(1)	31,108	30,231	68,738	73,261
Fulfillment partner	165,259	164,991	342,488	337,347
Total cost of goods sold	196,367	195,222	411,226	410,608
Gross profit	43,169	39,770	90,677	89,854
Operating expenses:				
Sales and marketing(1)	13,512	13,655	27,987	29,080
Technology(1)	15,122	16,808	30,760	33,468
General and administrative(1)	14,516	16,725	29,338	34,711
Restructuring			98	
Total operating expenses	43,150	47,188	88,183	97,259
Operating income (loss)	19	(7,418)	2,494	(7,405)
Interest income	27	46	56	98
Interest expense	(253)	(630)	(461)	(1,306)
Other income, net	719	220	1,151	409
Income (loss) before income taxes	512	(7,782)	3,240	(8,204)
Provision for income taxes	42	16	51	38
Net income (loss)	\$ 470	\$ (7,798)	\$ 3,189	\$ (8,242)
Deemed dividend related to redeemable common stock		(2)		(12)
Net income (loss) attributable to common shares	\$ 470	\$ (7,800)	\$ 3,189	\$ (8,254)
Net income (loss) per common share basic:				
Net income (loss) attributable to common shares basic	\$ 0.02	\$ (0.34)	\$ 0.14	\$ (0.36)
Weighted average common shares outstanding basic	23,437	23,265	23,382	23,240
Net income (loss) per common share diluted:				
Net income (loss) attributable to common shares diluted	\$ 0.02	\$ (0.34)	\$ 0.14	\$ (0.36)
Weighted average common shares outstanding diluted	23,464	23,265	23,399	23,240
Comprehensive income (loss)	\$ 470	\$ (7,798)	\$ 3,189	\$ (8,242)

(1) Includes stock-based compensation as follows (Note 7):

Cost of goods sold direct	\$ 66	\$ 45	\$ 126	\$ 87
Sales and marketing	51	103	152	209
Technology	191	173	367	362
General and administrative	522	511	998	1,050

Edgar Filing: OVERSTOCK.COM, INC - Form 10-Q

Total	\$	830	\$	832	\$	1,643	\$	1,708
-------	----	-----	----	-----	----	-------	----	-------

See accompanying notes to consolidated financial statements.

Table of Contents

Overstock.com, Inc.

Consolidated Statements of Changes in Stockholders' Equity

(Unaudited)

(in thousands)

	Common stock			Additional		Accumulated	Treasury stock		Total
	Shares	Amount		Paid-in		Deficit	Shares	Amount	
Balances at December 31, 2011	26,241	\$ 2	\$	353,368	\$	(261,765)	2,962	\$ (78,368)	\$ 13,237
Net income						3,189			3,189
Stock-based compensation to employees and directors				1,643					1,643
Common stock issued upon vesting of restricted stock	236								
Purchase of treasury stock							68	(464)	(464)
Balance at June 30, 2012	26,477	\$ 2	\$	355,011	\$	(258,576)	3,030	\$ (78,832)	\$ 17,605

See accompanying notes to consolidated financial statements.

Table of Contents

Overstock.com, Inc.

Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	Six months ended June 30,		Twelve months ended June 30,	
	2012	2011	2012	2011
Cash flows from operating activities:				
Net income (loss)	\$ 3,189	\$ (8,242)	\$ (8,007)	\$ 3,259
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization	8,096	8,263	16,183	16,197
Realized gain from sale of marketable securities	(7)		(7)	
Loss on disposition of fixed asset	61		61	
Stock-based compensation to employees and directors	1,643	1,708	2,986	4,279
Amortization of deferred loan costs and debt discount	37	60	104	242
(Gain) loss from early extinguishment of debt		27	1,226	(115)
Restructuring charges (reversals)	98		98	(433)
Changes in operating assets and liabilities:				
Restricted cash	(8)	147	351	533
Accounts receivable, net	3,417	6,918	(3,442)	1,643
Inventories, net	1,919	11,044	(4)	4,656
Prepaid inventories, net	(727)	405	(77)	1,041
Prepays and other assets	(2,890)	(4,321)	975	(3,160)
Other long-term assets, net	889	230	499	1,292
Accounts payable	(29,651)	(28,513)	1,806	(1,477)
Accrued liabilities	(12,352)	(8,773)	3,373	3,643
Deferred revenue	(3,715)	(2,573)	2,809	1,268
Other long-term liabilities	60	84	324	(144)
Net cash provided by (used in) operating activities	(29,941)	(23,536)	19,258	32,724
Cash flows from investing activities:				
Purchases of marketable securities	(55)	(79)	(136)	(152)
Sale of marketable securities	154		154	
Proceeds from sale of fixed assets	55		55	
Purchases of intangible assets	(6)		(10)	(396)
Investment in precious metals				(1,567)
Expenditures for fixed assets, including internal-use software and website development	(6,503)	(4,024)	(11,220)	(9,708)
Net cash used in investing activities	(6,355)	(4,103)	(11,157)	(11,823)
Cash flows from financing activities:				
Payments on capital lease obligations	(112)	(568)	(274)	(701)
Drawdowns on line of credit			17,000	
Capitalized financing costs			(140)	
Proceeds from finance obligations		748	681	17,131
Payments on finance obligations		(2,066)	(22,852)	(2,907)
Paydown on direct financing arrangement	(115)	(106)	(225)	(207)
Payments to retire convertible senior notes		(10,110)	(24,505)	(25,927)
Purchase of redeemable stock				(26)
Purchase of treasury stock	(464)	(1,600)	(468)	(1,607)
Exercise of stock options				15

Edgar Filing: OVERSTOCK.COM, INC - Form 10-Q

Net cash used in financing activities	(691)	(13,702)	(30,783)	(14,229)
Net increase (decrease) in cash and cash equivalents	(36,987)	(41,341)	(22,682)	6,672
Cash and cash equivalents, beginning of period	96,985	124,021	82,680	76,008
Cash and cash equivalents, end of period	\$ 59,998	\$ 82,680	\$ 59,998	\$ 82,680

Supplemental disclosures of cash flow

information:

Cash paid during the period:

Interest paid	\$ 294	\$ 1,191	\$ 1,472	\$ 2,383
Taxes paid	4	260	4	260

Non-cash investing and financing activities:

Change in fixed assets, including internal-use software and website development, costs financed through accounts payable and accrued liabilities	\$ 279	\$ 354	\$ (666)	\$ 3
Equipment acquired under finance obligations		3,686	1,391	4,285
Equipment and software acquired under capital lease obligations				6
Lapse of rescission rights of redeemable stock		473	109	733

See accompanying notes to consolidated financial statements.

Table of Contents

Overstock.com, Inc.

Notes to Unaudited Consolidated Financial Statements

1. BASIS OF PRESENTATION

As used herein, Overstock.com, we, our and similar terms include Overstock.com, Inc. and its subsidiaries, unless the context indicates otherwise. The accompanying unaudited consolidated financial statements have been prepared by us pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our audited annual consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2011. The accompanying unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, which are, in our opinion, necessary for a fair presentation of results for the interim periods presented. Preparing financial statements requires us to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on our best knowledge of current events and actions that we may undertake in the future, actual results may be different from the estimates. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

2. ACCOUNTING POLICIES

Principles of consolidation

The accompanying consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries. All intercompany account balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent liabilities in the consolidated financial statements and accompanying notes. Estimates are used for, but not limited to, investment valuation, receivables valuation, revenue recognition, sales returns, incentive discount offers, inventory valuation, depreciable lives of fixed assets and internally-developed software, goodwill valuation, intangible valuation, income taxes, stock-based compensation, performance-based compensation, restructuring liabilities and contingencies. Actual results could differ materially from those estimates.

Cash equivalents

We classify all highly liquid instruments, including money market funds with a remaining maturity of three months or less at the time of purchase, as cash equivalents. Cash equivalents were \$33.1 million and \$81.2 million at June 30, 2012 and December 31, 2011, respectively.

Restricted cash

We consider cash that is legally restricted and cash that is held as a compensating balance for letter of credit arrangements as restricted cash. Restricted cash was \$2.0 million and \$2.0 million at June 30, 2012 and December 31, 2011, respectively, and was held primarily in money market accounts.

Fair value of financial instruments

Our financial instruments, including cash, cash equivalents, accounts receivable, accounts payable and accrued liabilities are carried at cost, which approximates their fair value because of the short-term maturity of these instruments. We are party to a Financing Agreement with U.S. Bank dated December 22, 2009 (as amended to date, the Financing Agreement). Our Financing Agreement is also carried at face value, which approximates its fair value due to its variable interest rate.

We account for our assets and liabilities using a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. These two types of inputs have created the following fair-value hierarchy:

- Level 1 Quoted prices for identical instruments in active markets;
- Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are

Table of Contents

observable in active markets; and

- **Level 3** Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires us to minimize the use of unobservable inputs and to use observable market data, if available, when determining fair value.

The fair value of these financial instruments was determined using the following levels of inputs as of June 30, 2012 (in thousands):

	Total	Fair Value Measurements at June 30, 2012:		
		Level 1	Level 2	Level 3
Assets:				
Cash equivalents and restricted cash -				
Money market mutual funds	\$ 35,143	\$ 35,143	\$	\$
Trading securities held in a rabbi trust				
(1)	222	222		
Total assets	\$ 35,365	\$ 35,365	\$	\$
Liabilities:				
Deferred compensation accrual rabbi				
trust (2)	215	215		
Total liabilities	\$ 215	\$ 215	\$	\$

The fair value of these financial instruments was determined using the following levels of inputs as of December 31, 2011 (in thousands):

	Total	Fair Value Measurements at December 31, 2011:		
		Level 1	Level 2	Level 3
Assets:				
Cash equivalents and restricted cash -				
Money market mutual funds	\$ 83,195	\$ 83,195	\$	\$
Trading securities held in a rabbi trust				
(1)	302	302		
Total assets	\$ 83,497	\$ 83,497	\$	\$
Liabilities:				
Deferred compensation accrual rabbi				
trust (2)	302	302		
Total liabilities	\$ 302	\$ 302	\$	\$

(1) Trading securities held in a rabbi trust are included in Other current and long-term assets in the consolidated balance sheets

(2) Non qualified deferred compensation for rabbi trust is included in Accrued liabilities and Other long-term liabilities in the consolidated balance sheets.

Restricted investments

In December 2009, we implemented a Non Qualified Deferred Compensation Plan (the "NQDC Plan") for senior management. Deferred compensation amounts are invested in mutual funds held in a rabbi trust and are restricted for payment to the participants of the NQDC Plan. We account for our investments held in the trust in accordance with Accounting Standards Codification (ASC) No. 320 *Investments - Debt and Equity Securities*. The investments held in the trust are classified as trading securities. The fair value of the investments held in the trust totaled \$222,000 at June 30, 2012 and are included in Other current and long-term assets in the consolidated balance sheets. Our gains and losses on these investments were immaterial for the three and six months ended June 30, 2012 and 2011.

Accounts receivable

Accounts receivable consist primarily of trade amounts due from customers and from uncleared credit card transactions at period end. Accounts receivable are recorded at invoiced amounts and do not bear interest.

Allowance for doubtful accounts

From time to time, we grant credit to some of our business customers on normal credit terms (typically 30 days). We perform credit evaluations of our business customers' financial condition and payment history and maintain an allowance for doubtful accounts receivable based upon our historical collection experience and expected collectability of accounts receivable. The allowance for doubtful accounts receivable was \$625,000 and \$574,000 at June 30, 2012 and December 31, 2011, respectively.

Table of Contents

Concentration of credit risk

Cash equivalents include short-term, highly liquid instruments with maturities at date of purchase of three months or less. At June 30, 2012 and December 31, 2011, two banks held the majority of our cash and cash equivalents. We do not believe that, as a result of this concentration, we are subject to any unusual financial risk beyond the normal risk associated with commercial banking relationships.

Financial instruments that potentially subject us to significant concentrations of credit risk consist primarily of cash equivalents and receivables. We invest our cash primarily in money market securities which are uninsured.

Our accounts receivable are derived primarily from revenue earned from customers located in the United States. We maintain an allowance for doubtful accounts based upon the expected collectability of accounts receivable.

Valuation of inventories

Inventories, consisting of merchandise purchased for resale, are accounted for using a standard costing system which approximates the first-in-first-out (FIFO) method of accounting, and are valued at the lower of cost or market. We write down our inventory for estimated obsolescence and to lower of cost or market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Once established, the original cost of the inventory less the related inventory allowance represents the new cost basis of such products. Reversal of the allowance is recognized only when the related inventory has been sold or scrapped.

Prepaid inventories, net

Prepaid inventories represent inventories paid for in advance of receipt. Prepaid inventories were \$1.8 million and \$1.0 million at June 30, 2012 and December 31, 2011, respectively.

Prepays and other assets

Prepays and other assets represent expenses paid prior to receipt of the related goods or services, including advertising, license fees, maintenance, packaging, insurance, and other miscellaneous costs, as well as investments in precious metals. Total prepaids and other assets were \$15.1 million and \$12.7 million at June 30, 2012 and December 31, 2011, respectively.

Fixed assets

Fixed assets, which include assets such as technology infrastructure, internal-use software, website development, furniture and fixtures and leasehold improvements, are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the related assets or the term of the related capital lease, whichever is shorter, as follows:

	Life (years)
Computer software	2-3
Computer hardware	3
Furniture and equipment	3-5

Leasehold improvements are amortized over the shorter of the term of the related leases or estimated useful lives.

Table of Contents

Depreciation and amortization expense is classified within the corresponding operating expense categories on the consolidated statements of operations as follows (in thousands):

	Three months ended June 30,				Six months ended June 30,			
	2012		2011		2012		2011	
Cost of goods sold - direct	\$	120	\$	218	\$	228	\$	446
Technology		3,600		3,761		7,199		7,243
General and administrative		342		285		669		574
Total depreciation and amortization, including internal-use software and website development	\$	4,062	\$	4,264	\$	8,096	\$	8,263

Internal-use software and website development

Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our Website and processes supporting our business. We capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of two to three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During the three months ended June 30, 2012 and 2011, we capitalized \$2.4 million and \$3.7 million, respectively, of costs associated with internal-use software and website development, both developed internally and acquired externally. Amortization of costs associated with internal-use software and website development was \$2.2 million and \$2.1 million for those respective periods. During the six months ended June 30, 2012 and 2011, we capitalized \$3.9 million and \$5.6 million, respectively, of such costs and had amortization of \$4.3 million and \$4.0 million for those respective periods.

Revenue recognition

We derive our revenue primarily from two sources: direct revenue and fulfillment partner revenue, including listing fees and commissions collected from products being listed and sold through our cars listing business, and from advertising on our shopping, travel and insurance pages. We have organized our operations into two principal segments based on the primary source of revenue: direct revenue and fulfillment partner revenue (see Note 8 Business Segments).

Revenue is recognized when the following revenue recognition criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or the service has been provided; (3) the selling price or fee revenue earned is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. Revenue related to merchandise sales is recognized upon delivery to our customers. As we ship high volumes of packages through multiple carriers, it is not practical for us to track the actual delivery date of each shipment. Therefore, we use estimates to determine which shipments are delivered and, therefore, recognized as revenue at the end of the period. Our delivery date estimates are based on average shipping transit times, which are calculated using the following factors: (i) the type of shipping carrier (as carriers have different in-transit times); (ii) the fulfillment source (either our warehouses or those of our fulfillment partners); (iii) the delivery destination; and (iv) actual transit time experience, which shows that delivery date is typically one to eight business days from the date of shipment. We review

Edgar Filing: OVERSTOCK.COM, INC - Form 10-Q

and update our estimates on a quarterly basis based on our actual transit time experience. However, actual shipping times may differ from our estimates.

We evaluate the criteria outlined in ASC Topic 605-45, *Principal Agent Considerations*, in determining whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned as commissions. When we are the primary obligor in a transaction, are subject to inventory risk, have latitude in establishing prices and selecting suppliers, or have several but not all of these indicators, revenue is recorded gross. If we are not the primary obligor in the transaction and amounts earned are determined using a fixed percentage, revenue is recorded on a net basis. Currently, the majority of both direct revenue and fulfillment partner revenue is recorded on a gross basis, as we are the primary obligor. We present revenue net of sales taxes.

We periodically provide incentive offers to our customers to encourage purchases. Such offers include current discount offers, such as percentage discounts off current purchases and other similar offers, which, when used by customers, are treated as a reduction of revenue.

Based upon our historical experience, revenue typically increases during the fourth quarter because of the holiday retail season.

Direct revenue

Direct revenue is derived from merchandise sales to individual consumers and businesses that are fulfilled from our leased warehouses. Direct revenue comes from sales that occur primarily through our Website, but may also occur through offline channels.

Table of Contents

Fulfillment partner revenue

Fulfillment partner revenue is derived from merchandise sales through our Website which fulfillment partners ship directly to consumers and businesses from warehouses maintained by our fulfillment partners.

Fulfillment partner revenue also includes revenue from our other businesses, which include our online site for listing cars for sale, our travel shopping site, our insurance shopping site, our consignment service to suppliers, our online auction site (which was removed from our site in July 2011) and our online site for listing real estate for sale (which was removed from our site in June 2011). Revenue from our other businesses is less than 1% of total net revenues.

Club O loyalty program

We have a customer loyalty program called Club O for which we sell annual memberships. We record membership fees as deferred revenue and we recognize revenue ratably over the membership period. The Club O loyalty program allows members to earn reward dollars for qualifying purchases made on our Website. We also have a co-branded credit card program (see Co-branded credit card revenue below for more information). Co-branded cardholders are also Club O members and earn additional reward dollars for purchases made on our Website, and from other merchants. Reward dollars earned may be redeemed on future purchases made through our Website. Club O reward dollars expire 90 days after the customer's Club O membership expires. We account for these transactions as multiple element arrangements and allocate value to the elements using their relative fair values. We include the value of reward dollars earned in deferred revenue and we record it as a reduction of revenue at the time the reward dollars are earned.

We recognize revenue for Club O reward dollars when: (i) customers redeem their reward dollars as part of a purchase at our Website, (ii) reward dollars expire or (iii) the likelihood of reward dollars being redeemed by a customer is remote (reward dollar breakage). Due to the loyalty program's short history, currently no reward dollar breakage is recognized until the reward dollars expire. However, in the future we plan to recognize such breakage based upon historical redemption patterns.

In instances where customers receive free Club O reward dollars not associated with any purchases, we account for these transactions as sales incentives such as coupons and record a reduction of revenue at the time the reward dollars are redeemed.

Co-branded credit card program

We have entered into a co-branded credit card agreement with a commercial bank for the issuance of credit cards bearing the Overstock.com brand, under which the bank pays us fees for new accounts and for customer usage of the cards. The agreement also provides for a customer loyalty program offering reward points that customers will accrue from card usage and can use to make purchases on our Website (See Club O loyalty program above for more information). New account fees are recognized as revenue on a straight-line basis over the estimated life of the credit card relationship. Credit card usage fees are recognized as revenues as actual credit card usage occurs.

Deferred revenue

Customer orders are recorded as deferred revenue prior to delivery of products or services ordered. We record amounts received for Club O membership fees as deferred revenue and we recognize it ratably over the membership period. We record Club O reward dollars earned from purchases as deferred revenue at the time they are earned and we recognize it as revenue upon redemption. If reward dollars are not redeemed, we recognize revenue upon expiration. In addition, we sell gift cards and record related deferred revenue at the time of the sale. We sell gift cards without expiration dates and we recognize revenue from a gift card upon redemption of the gift card. If a gift card is not redeemed, we recognize income when the likelihood of its redemption becomes remote based on our historical redemption experience. We consider the likelihood of redemption to be remote after 36 months.

Sales returns allowance

We inspect returned items when they arrive at our processing facility. We refund the full cost of the merchandise returned and all original shipping charges if the returned item is defective or we or our fulfillment partners have made an error, such as shipping the wrong product.

If the return is not a result of a product defect or a fulfillment error and the customer initiates a return of an unopened item within 30 days of delivery, for most products we refund the full cost of the merchandise minus the original shipping charge and actual return shipping fees. However, we reduce refunds for returns initiated more than 30 days after delivery or that are received at our returns processing facility more than 45 days after initial delivery.

Table of Contents

If our customer returns an item that has been opened or shows signs of wear, we issue a partial refund minus the original shipping charge and actual return shipping fees.

Revenue is recorded net of estimated returns. We record an allowance for returns based on current period revenues and historical returns experience. We analyze actual historical returns, current economic trends and changes in order volume and acceptance of our products when evaluating the adequacy of the sales returns allowance in any accounting period.

The allowance for returns was \$5.7 million and \$10.9 million at June 30, 2012 and December 31, 2011 respectively. The decrease in allowance for returns at June 30, 2012 compared to December 31, 2011 is primarily due to decreased revenues mostly due to seasonality.

Credit card chargeback allowance

Revenue is recorded net of credit card chargebacks. We maintain an allowance for credit card chargebacks based on current period revenues and historical chargeback experience. The allowance for chargebacks was \$134,000 and \$187,000 at June 30, 2012 and December 31, 2011, respectively.

Cost of goods sold

Cost of goods sold includes product costs, warehousing costs, outbound shipping costs, handling and fulfillment costs, customer service costs and credit card fees, and is recorded in the same period in which related revenues have been recorded. Cost of goods sold, including product cost and other costs and fulfillment and related costs are as follows (in thousands):

Total revenue, net	\$	239,536	100%	\$	234,992	100%	\$ 501,903
							\$ 500,462