

PFSWEB INC
Form 10-Q
August 15, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the Quarterly Period Ended June 30, 2011

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

75-2837058

(State of Incorporation)

(I.R.S. Employer I.D. No.)

500 North Central Expressway, Plano, Texas

75074

(Address of principal executive offices)

(Zip Code)

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

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

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate website, 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 or a non-accelerated filer.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting
Company

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No
At August 12, 2011 there were 12,648,789 shares of registrant's common stock outstanding.

PFSWEB, INC. AND SUBSIDIARIES
Form 10-Q
June 30, 2011
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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements**

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

| | June 30, 2011 | December 31, 2010 |
|-------------------------------------------------------------------------------------------------------------------------------------|--------------------------|----------------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 18,959 | \$ 18,430 |
| Restricted cash | 1,267 | 1,853 |
| Accounts receivable, net of allowance for doubtful accounts of \$718 and \$754 at June 30, 2011 and December 31, 2010, respectively | 37,225 | 41,438 |
| Inventories, net of reserves of \$1,582 and \$1,561 at June 30, 2011 and December 31, 2010, respectively | 38,985 | 35,161 |
| Assets of discontinued operations | | 2,776 |
| Other receivables | 12,779 | 14,539 |
| Prepaid expenses and other current assets | 4,405 | 3,580 |
| Total current assets | 113,620 | 117,777 |
| PROPERTY AND EQUIPMENT, net | 10,775 | 9,124 |
| ASSETS OF DISCONTINUED OPERATIONS | | 1,126 |
| OTHER ASSETS | 2,216 | 2,203 |
| Total assets | \$ 126,611 | \$ 130,230 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt and capital lease obligations | \$ 19,191 | \$ 18,320 |
| Trade accounts payable | 49,134 | 55,692 |
| Deferred revenue | 5,470 | 5,254 |
| Accrued expenses | 18,690 | 15,870 |
| Total current liabilities | 92,485 | 95,136 |
| LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion | 1,135 | 2,136 |
| OTHER LIABILITIES | 4,074 | 3,608 |
| Total liabilities | 97,694 | 100,880 |

COMMITMENTS AND CONTINGENCIES

SHAREHOLDERS' EQUITY:

| | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued and outstanding | | |
| Common stock, \$0.001 par value; 35,000,000 shares authorized; 12,667,150 and 12,255,064 shares issued at June 30, 2011 and December 31, 2010, respectively; and 12,648,789 and 12,236,703 outstanding at June 30, 2011 and December 31, 2010, respectively | 13 | 12 |
| Additional paid-in capital | 103,511 | 101,229 |
| Accumulated deficit | (76,833) | (73,332) |
| Accumulated other comprehensive income | 2,311 | 1,526 |
| Treasury stock at cost, 18,361 shares | (85) | (85) |
| Total shareholders' equity | 28,917 | 29,350 |
| Total liabilities and shareholders' equity. | \$ 126,611 | \$ 130,230 |

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

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|-------------------|-------------------------|-------------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| REVENUES: | | | | |
| Product revenue, net | \$ 38,799 | \$ 43,654 | \$ 84,082 | \$ 89,276 |
| Service fee revenue | 20,970 | 16,567 | 39,870 | 32,546 |
| Pass-through revenue | 8,239 | 6,186 | 16,445 | 12,820 |
| Total revenues | 68,008 | 66,407 | 140,397 | 134,642 |
| COSTS OF REVENUES: | | | | |
| Cost of product revenue | 35,411 | 40,623 | 77,877 | 82,985 |
| Cost of service fee revenue | 15,795 | 11,987 | 29,578 | 23,441 |
| Cost of pass-through revenue | 8,239 | 6,186 | 16,445 | 12,820 |
| Total costs of revenues | 59,445 | 58,796 | 123,900 | 119,246 |
| Gross profit | 8,563 | 7,611 | 16,497 | 15,396 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES , including stock based compensation expense of \$399 and \$262 in the three months ended June 30, 2011 and 2010, respectively and \$709 and \$358 in the six months ended June 30, 2011 and 2010, respectively | 9,430 | 8,378 | 18,718 | 16,986 |
| Loss from operations | (867) | (767) | (2,221) | (1,590) |
| INTEREST EXPENSE , net | 270 | 234 | 461 | 488 |
| Loss from continuing operations before income taxes | (1,137) | (1,001) | (2,682) | (2,078) |
| INCOME TAX EXPENSE | 95 | 54 | 230 | 180 |
| LOSS FROM CONTINUING OPERATIONS INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX | (1,232) | (1,055) | (2,912) | (2,258) |
| NET LOSS | \$ (1,218) | \$ (1,495) | \$ (3,501) | \$ (2,704) |
| LOSS PER SHARE FROM CONTINUING OPERATIONS: | | | | |
| Basic | \$ (0.10) | \$ (0.10) | \$ (0.23) | \$ (0.22) |
| Diluted | \$ (0.10) | \$ (0.10) | \$ (0.23) | \$ (0.22) |
| LOSS PER SHARE INCLUDING DISCONTINUED OPERATIONS: | | | | |

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| | | | | |
|---------|-----------|-----------|-----------|-----------|
| Basic | \$ (0.10) | \$ (0.14) | \$ (0.28) | \$ (0.26) |
| Diluted | \$ (0.10) | \$ (0.14) | \$ (0.28) | \$ (0.26) |

WEIGHTED AVERAGE NUMBER OF SHARES
OUTSTANDING:

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 12,567 | 10,796 | 12,418 | 10,369 |
| Diluted | 12,567 | 10,796 | 12,418 | 10,369 |

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

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

| | Six Months Ended | |
|---------------------------------------------------------------------------------|-------------------------|-------------|
| | June 30, | |
| | 2011 | 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (3,501) | \$ (2,704) |
| Loss from discontinued operations | (589) | (446) |
| Loss from continuing operations | (2,912) | (2,258) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,038 | 3,134 |
| Provision for doubtful accounts | 22 | 76 |
| Provision for excess and obsolete inventory | 17 | 64 |
| Deferred income taxes | 32 | (8) |
| Stock-based compensation expense | 709 | 358 |
| Changes in operating assets and liabilities: | | |
| Restricted cash | 75 | 108 |
| Accounts receivable | 4,987 | 2,985 |
| Inventories, net | (2,540) | 513 |
| Prepaid expenses, other receivables and other assets | 1,568 | (803) |
| Accounts payable, deferred revenue, accrued expenses and other liabilities | (5,378) | (619) |
| Net cash provided by (used in) continuing operating activities | (382) | 3,550 |
| Net cash provided by (used in) discontinued operating activities | 1,254 | (388) |
| Net cash provided by operating activities | 872 | 3,162 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (4,016) | (1,876) |
| Proceeds from sale of eCOST subsidiary | 2,327 | |
| Net cash used in investing activities | (1,689) | (1,876) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net proceeds from issuance of common stock | 1,574 | 7,286 |
| Decrease in restricted cash | 511 | 578 |
| Payments on capital lease obligations | (488) | (738) |
| Payments on debt, net | (537) | (3,256) |
| Net cash provided by financing activities | 1,060 | 3,870 |
| EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS | 286 | (558) |

| | | |
|------------------------------------------------|-----------|-----------|
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 529 | 4,598 |
| CASH AND CASH EQUIVALENTS, beginning of period | 18,430 | 14,812 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 18,959 | \$ 19,410 |

SUPPLEMENTAL CASH FLOW INFORMATION

Non-cash investing and financing activities:

| | | |
|---------------------------------------------------------------|--------|--------|
| Property and equipment acquired under debt and capital leases | \$ 685 | \$ 355 |
|---------------------------------------------------------------|--------|--------|

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

Table of Contents**PFSweb, Inc. and Subsidiaries****Notes to Unaudited Interim Consolidated Financial Statements****I. OVERVIEW AND BASIS OF PRESENTATION**

PFSweb, Inc. and its subsidiaries are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; Retail Connect refers to PFSweb Retail Connect, Inc.; and PFS refers to Priority Fulfillment Services, Inc. and its subsidiaries and affiliates, excluding Supplies Distributors and Retail Connect. In connection with the sale of certain of the assets of eCOST.com, Inc. (eCOST) described below, the name of eCOST was changed to PFSweb Retail Connect, Inc. in March 2011.

PFS Overview

PFS is an international business process outsourcing provider of end-to-end eCommerce solutions to major brand name companies seeking to optimize their supply chain and to enhance their traditional and online business channels and initiatives in the United States, Canada, and Europe. PFS offers a broad range of service offerings that include digital marketing, eCommerce technologies, order management, customer care, logistics and fulfillment, financial management and professional consulting.

Supplies Distributors Overview

Supplies Distributors, PFS and InfoPrint Solutions Company (IPS), a wholly-owned subsidiary of RICOH Company Limited, 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 that allows it to fund the working capital requirements for the sale of primarily IPS products. Pursuant to the transaction management services agreements between PFS and Supplies Distributors, PFS 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 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 PFS and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFS 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

Until February 2011 the Company operated eCOST primarily as a multi-category online discount retailer of new, close-out and recertified brand-name merchandise, which sold products primarily to customers in the United States. In February 2011 the Company sold substantially all of the inventory and certain intangible assets of the eCOST discount retailer business unit for a cash purchase price of \$2.3 million (before expenses of approximately \$0.2 million) and the assumption by the purchaser of certain limited liabilities of eCOST. The purchase price represented approximately \$1 million for inventory and the balance for the intangible assets. In connection with the closing of this business unit, the Company incurred exit costs of approximately \$0.3 million related to employee termination costs, excess property and equipment and certain contract termination costs and may incur additional costs, including excess facility costs. In December 2010, the Company recorded a non-cash goodwill impairment charge of approximately \$2.8 million as a result of this sale. For all periods presented, the Company has reported the operating results of the eCOST discount retailer business unit, excluding costs expected to continue to occur in the future, as discontinued

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operations. The remaining assets and business operations of eCOST will be conducted under the name PFSweb Retail Connect and will continue to provide certain services, primarily under a product ownership based model, to certain of the Company's client relationships on an ongoing basis.

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of June 30, 2011, and for the three and six months ended June 30, 2011 and 2010, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim consolidated financial statements of the Company include all adjustments necessary for a fair presentation of the Company's financial position as of June 30, 2011, its results of operations for the three and six months ended June 30, 2011 and 2010 and its cash flows for the six months ended June 30, 2011 and 2010. Results of the Company's operations for interim periods may not be indicative of results for the full fiscal year.

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

2. SIGNIFICANT ACCOUNTING POLICIES***Principles of Consolidation***

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements 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 selling, general and administrative expenses in these consolidated financial statements also require management estimates and assumptions.

Estimates and assumptions about future events and their effects cannot be determined with certainty. The Company bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as the operating environment changes. These changes have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 in the section entitled Risk Factors. Based on a critical assessment of accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes the Company's consolidated financial statements are fairly stated in accordance with generally accepted accounting principles in the United States of America, and provide a fair presentation of the Company's financial position and results of operations.

Investment in Affiliates

PFS has made advances to Suppliers 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

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balance of the Subordinated Note cannot be increased to more than \$5.0 million or decreased to less than \$3.5 million without prior approval of the Company's lenders. At June 30, 2011 and December 31, 2010, the outstanding balance of the Subordinated Note was \$4.3 million in both periods. The Subordinated Note is eliminated in the Company's consolidated financial statements.

PFS has also made advances to Retail Connect, which aggregated \$11.1 million as of both June 30, 2011 and December 31, 2010. Certain terms of the Company's debt facilities provide that the total advances to Retail Connect may not be less than \$2.0 million without prior approval of Retail Connect's lender, if needed. PFSweb, Inc. has also advanced to Retail Connect an additional \$7.4 million as of both June 30, 2011 and December 31, 2010. The PFS and PFSweb advances are eliminated in the Company's consolidated financial statements.

Concentration of Business and Credit Risk

The Company's service fee revenue is generated under contractual service fee relationships with multiple client relationships. No service fee client or product revenue customer exceeded 10% of the Company's consolidated total net revenue or accounts receivable during the six months ended June 30, 2011. A summary of the nonaffiliated customer and client concentrations is as follows:

| | Six Months Ended | |
|---------------------------------------------------------------|-------------------------|-------------|
| | June 30, | |
| | 2011 | 2010 |
| Product Revenue (as a percentage of Product Revenue): | | |
| Customer 1 | 15% | 16% |
| Customer 2 | 11% | 12% |
| Service Fee Revenue (as a percentage of Service Fee Revenue): | | |
| Client 1 | 14% | 6% |
| Client 2 | 14% | 4% |
| Client 3 | 1% | 13% |

PFS previously operated three distinct geographical contract arrangements with Client 3, which are aggregated in the service fee revenue percentages reflected above. As of June 30, 2011, substantially all of Client 3's contracts with PFS had expired in accordance with their terms and were not renewed.

The Company 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 International Business Machines Corporation (IBM) and IPS and is dependent upon the continuation of such arrangements. These arrangements, which are critical to the Company's ongoing operations, include Supplies Distributors' master distributor agreements and certain of Supplies Distributors' working capital financing agreements. Substantially all of the Supplies Distributors' revenue is generated by its sale of product purchased from IPS. Supplies Distributors also relies upon IPS' sales force and product demand generation activities and the discontinuance of such services would have a material impact upon Supplies Distributors' business. In addition, Supplies Distributors has product sales to IBM and IPS business affiliates and the Company has an IBM term master lease agreement applicable to its financing of property and equipment.

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

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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 its IPS master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined. In the event PFS, 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.

Property and Equipment

The Company's property held under capital leases amounted to approximately \$1.7 million and \$1.5 million, net of accumulated amortization of approximately \$2.0 million and \$2.8 million, at June 30, 2011 and December 31, 2010, respectively.

Cash Paid for Interest and Taxes

The Company made payments for interest of approximately \$0.5 million in each of the six month periods ended June 30, 2011 and 2010. Income taxes of approximately \$0.3 million were paid by the Company during both the six month periods ended June 30, 2011 and 2010.

Impact of Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board issued new accounting guidance regarding the presentation of comprehensive income. The new guidance requires the presentation of items of net income and comprehensive income in either a single continuous financial statement or in two separate but consecutive financial statements. This account guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The impact of adoption will not have a material effect on the Company's consolidated financial statements as it only requires a change in the format of the Company's current presentation.

3. COMPREHENSIVE LOSS (in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-----------------------------------------|--------------------------------|------------|------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Net loss | \$ (1,218) | \$ (1,495) | \$ (3,501) | \$ (2,704) |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustment | 190 | (812) | 785 | (1,440) |
| Comprehensive loss | \$ (1,028) | \$ (2,307) | \$ (2,716) | \$ (4,144) |

4. 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. For the three and six months ended June 30, 2011 and 2010, outstanding options to purchase common shares of 2.4 million in each period were anti-dilutive and have been excluded from the diluted weighted average share computation.

5. STOCK AND STOCK OPTIONS

In May 2010, the Company completed a public offering pursuant to which the Company issued and sold an aggregate of 2.3 million shares of common stock, par value \$.001 per share, at \$3.50 per share, resulting in net proceeds after deducting offering expenses of \$7.3 million.

During the six months ended June 30, 2011 and 2010, the Company issued an aggregate of 660,000 and 650,000 options, respectively, to purchase shares of common stock to officers, directors, employees and consultants of the Company.

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

6. VENDOR FINANCING:

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

| | June 30, 2011 | December 31, 2010 |
|-----------------------------------------------------|--------------------------|----------------------------------|
| Inventory and working capital financing agreements: | | |
| United States | \$ 18,143 | \$ 16,472 |
| Europe | 17,720 | 11,318 |
| Total | \$ 35,863 | \$ 27,790 |

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 certain receivables up to \$25.0 million through its expiration in March 2012. As of June 30, 2011, Supplies Distributors had \$4.3 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 other direct or indirect Company subsidiaries), 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 guarantee of PFS and a Company parent guarantee. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$3.5 million and the Company is required to maintain 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% as of June 30, 2011). The facility also includes a monthly service fee. 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.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors' European subsidiary has a short-term credit facility with IBM Belgium Financial Services S.A. (IBM Belgium) to finance its distribution of IPS products in Europe. The asset based credit facility with IBM Belgium provides up to 16.0 million euros (approximately \$23.0 million as of June 30, 2011) in inventory financing and cash advances based on eligible inventory and accounts receivable through its expiration in March 2012. As of June 30, 2011, Supplies Distributors' European subsidiaries had 3.0 million euros (approximately \$4.3 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiary to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), 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 subsidiary, as well as collateralized guarantees of Supplies Distributors and PFS and a Company parent guarantee. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$3.5 million and the Company is required to maintain a minimum shareholders' equity of \$18.0 million. Borrowings under the credit facility accrue interest at Euribor plus 1.82% for cash advances, and, after a defined free financing period, at Euribor plus 4.1% for inventory financings. As of June 30, 2011, the interest rate was 5.4% on the \$17.7 million of outstanding inventory financings. Supplies Distributors' European

subsidiary pays a monthly service fee on the commitment. Given the structure of this facility and as outstanding inventory financing

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balances are repaid within twelve months, the Company has classified the outstanding inventory financing amounts under this facility as accounts payable in the consolidated balance sheets.

7. DEBT AND CAPITAL LEASE OBLIGATIONS:

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

| | June 30, 2011 | December 31, 2010 |
|---------------------------------------------|--------------------------|----------------------------------|
| Loan and security agreements, United States | | |
| Supplies Distributors | \$ 8,164 | \$ 7,220 |
| PFS | 5,250 | 6,000 |
| Credit facility Retail Connect | | |
| Factoring agreement, Europe | 2,385 | 2,302 |
| Taxable revenue bonds | 800 | 1,600 |
| Master lease agreements | 2,438 | 2,660 |
| Other | 1,289 | 674 |
| Total | 20,326 | 20,456 |
| Less current portion of long-term debt | 19,191 | 18,320 |
| Long-term debt, less current portion | \$ 1,135 | \$ 2,136 |

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Wells Fargo Bank, National Association (Wells Fargo) to provide financing for up to \$25 million of eligible accounts receivable in the United States and Canada. As of June 30, 2011, based on the available borrowing collateral balances, Supplies Distributors did not have available credit under this agreement. The Wells Fargo facility expires on the earlier of March 2014 or the date on which the parties to the IPS master distributor agreement no longer operate under the terms of such agreement and/or IPS no longer supplies products pursuant to such agreement. Borrowings under the Wells Fargo facility accrue interest at prime rate plus 0.25% to 0.75% (3.75% as of June 30, 2011) or Eurodollar rate plus 2.5% to 3.0%, dependent on excess availability and subject to a minimum of 3.0%, as defined. The interest rate as of June 30, 2011 was 3.75% for \$6.2 million of outstanding borrowings and 3.0% for \$2.0 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 other direct or indirect Company subsidiaries), 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 guarantee of PFS and a Company parent guarantee. Additionally, PFS is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than \$3.5 million and may not maintain restricted cash of more 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 Wells Fargo pursuant to which a security interest was granted to Wells Fargo for all U.S. and Canadian customer remittances received in specified bank accounts. At June 30, 2011 and December 31, 2010, these bank accounts held \$1.0 million and \$0.8 million, respectively, which was restricted for payment to Wells Fargo.

Loan and Security Agreement PFS

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 September 2012. The

Comerica Agreement also allows for up to \$12.5 million of eligible accounts receivable financing during certain seasonal peak months. As of June 30, 2011, PFS had \$4.7 million of available credit under this facility. Borrowings under the Comerica Agreement accrue interest at a defined rate, which will generally be prime rate plus 2%, with a minimum of 4.5% (5.25% at June 30, 2011). The Comerica Agreement contains cross default provisions, various restrictions upon PFS ability to, among

Table of Contents**PFSweb, Inc. and Subsidiaries****Notes to Unaudited Interim Consolidated Financial Statements**

other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), 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 \$5.0 million. Comerica has provided approval for PFS to advance incremental amounts subject to certain cash inflows to PFS, as defined, to certain of its subsidiaries and/or affiliates, if needed. The Comerica Agreement is secured by all of the assets of PFS, as well as a Company parent guarantee.

Credit Facility Retail Connect

Retail Connect has an asset-based line of credit facility of up to \$7.5 million from Wachovia Bank, N.A. (Wachovia), through May 2012, which is collateralized by substantially all of Retail Connect's assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory up to a specified amount. Outstanding borrowings under the facility bear interest at prime rate plus 1% or Eurodollar rate plus 3.5%. There were no outstanding borrowings as of June 30, 2011. As of June 30, 2011, Retail Connect had \$0.1 million of letters of credit outstanding and \$0.1 million of available credit under this facility. Subsequent to the sale of certain assets in February 2011, amounts available under the outstanding letter of credit are secured by restricted cash in equivalent amounts until expiration. In connection with the line of credit, Retail Connect entered into a cash management arrangement whereby Retail Connect's operating amounts are considered restricted and swept and used to repay outstanding amounts under the line of credit, if any. As of June 30, 2011 and December 31, 2010, the restricted cash amount was \$0.1 million and \$0.2 million, respectively. The credit facility restricts Retail Connect's ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including other direct or indirect Company subsidiaries), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth for Retail Connect of \$0 million, as defined. The Company has guaranteed all current and future obligations of Retail Connect under this line of credit.

Factoring Agreement

Supplies Distributors' European subsidiary has a factoring agreement with BNP Paribas Fortis that provides factoring for up to 7.5 million euros (approximately \$10.8 million as of June 30, 2011) of eligible accounts receivables through March 2014. This factoring agreement is accounted for as a secured borrowing. Borrowings accrue interest at Euribor plus 0.7% (2.0% at June 30, 2011). This agreement contains certain financial covenants, including minimum tangible net worth.

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 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 one of the Company's Southaven, Mississippi distribution facilities. The Bonds bear interest at a variable rate (0.3% as of June 30, 2011), 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) 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 2012. The Bonds require a final principal repayment of \$800,000 in January of

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PFSweb, Inc. and Subsidiaries

Notes to Unaudited Interim Consolidated Financial Statements

2012. PFS obligations under the Reimbursement Agreement are secured by substantially all of the assets of PFS and a Company parent guarantee.

Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with 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, if PFS service fee revenue declines from expected levels and it is unable to reduce costs to correspond to such reduced revenue levels or if Supplies Distributors revenue or gross profit declines from expected levels, such events may result in a breach of 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 guarantee. 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. As of June 30, 2011, the Company was in compliance with all debt covenants.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit Corporation (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of three years. The amounts outstanding under this Master Lease Agreement (\$0.6 million as of June 30, 2011 and \$1.0 million as of December 31, 2010) are secured by the related equipment and a Company parent guarantee.

The Company has other leasing and financing agreements and will continue to enter into such 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, and in certain cases, by a Company parent guarantee.

Table of Contents**PFSweb, Inc. and Subsidiaries****Notes to Unaudited Interim Consolidated Financial Statements****8. SEGMENT INFORMATION**

The Company is currently organized into two primary operating segments, which generally align with the corporate organization structure. In the first segment, PFS is an international provider of various business process outsourcing solutions and operates as a service fee business. In the second operating segment (Business and Retail Connect), subsidiaries of the Company purchase inventory from clients and resell the inventory to client customers. In this segment, the Company generally recognizes product revenue.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------------------------------|----------------------------------------|-------------|--------------------------------------|----------------------------------|
| | 2011 | 2010 | 2011 | 2010 |
| Revenues (in thousands): | | | | |
| PFS | \$ 30,798 | \$ 24,506 | \$ 59,568 | \$ 48,822 |
| Business and Retail Connect | 38,799 | 43,654 | 84,082 | 89,276 |
| Eliminations | (1,589) | (1,753) | (3,253) | (3,456) |
| | \$ 68,008 | \$ 66,407 | \$ 140,397 | \$ 134,642 |
| Income (loss) from continuing operations (in thousands): | | | | |
| PFS | \$ (1,729) | \$ (1,376) | \$ (3,648) | \$ (3,012) |
| Business and Retail Connect | 497 | 321 | 736 | 754 |
| Eliminations | | | | |
| | \$ (1,232) | \$ (1,055) | \$ (2,912) | \$ (2,258) |
| Depreciation and amortization (in thousands): | | | | |
| PFS | \$ 1,536 | \$ 1,573 | \$ 3,024 | \$ 3,119 |
| Business and Retail Connect | 7 | 7 | 14 | 15 |
| Eliminations | | | | |
| | \$ 1,543 | \$ 1,580 | \$ 3,038 | \$ 3,134 |
| Capital expenditures (in thousands): | | | | |
| PFS | \$ 2,639 | \$ 978 | \$ 3,996 | \$ 1,854 |
| Business and Retail Connect | 17 | 12 | 20 | 22 |
| Eliminations | | | | |
| | \$ 2,656 | \$ 990 | \$ 4,016 | \$ 1,876 |
| Assets (in thousands): | | | June 30, 2011 | December 31, 2010 |
| PFS | | | \$ 66,144 | \$ 62,617 |
| Business and Retail Connect | | | 76,489 | 82,175 |
| Eliminations | | | (16,022) | (14,562) |

\$ 126,611 \$ 130,230

9. COMMITMENTS AND CONTINGENCIES

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. In December 2006, the Company received notice that the municipal authority planned to make an adjustment to the Company's tax abatement. The Company disputed the adjustment and such dispute has been settled with the municipality. However, the amount of additional property taxes to be assessed against the Company and the timing of the related payments has not been finalized. As of June 30, 2011, the Company believes it has adequately accrued for the expected assessment.

In April 2010, a sales employee of eCOST was charged with violating various federal criminal statutes in connection with the sales of eCOST products to certain customers, and approximately \$620,000 held in an eCOST deposit account was seized and turned over to the Office of the U.S. Attorney in connection with such activity. The Company received subpoenas from the Office of the U.S. Attorney requesting information regarding the employee and other matters, and the Company has responded to the subpoenas and is fully cooperating with the Office of the U.S. Attorney. The Company has commenced its own

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investigation into the actions of the employee. Neither the Company nor eCOST have been charged with any criminal activity, and the Company intends to seek the recovery or reimbursement of the funds which are currently classified as other receivables in the June 30, 2011 financial statements. Based on the information available to date, the Company is unable to determine the amount of the loss, if any, relating to the seizure of such funds. No assurance can be given, however, that the seizure of such funds, or the inability of the Company to recover such funds or any significant portion thereof, or any costs and expenses incurred by the Company in connection with this matter will not have a material adverse effect upon the Company's financial condition or results of operations.

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. PFS is generally required to indemnify its service fee clients against any third party claims alleging infringement by PFS of the patents, trademarks and other intellectual property rights of third parties.

10. DISCONTINUED OPERATIONS

In February 2011, the Company sold certain assets of eCOST to a third party for a total aggregate cash purchase price of approximately \$2.3 million (before expenses of approximately \$0.2 million). Accordingly, the accompanying consolidated financial statements reflect the related operating results of the eCOST segment as discontinued operations for all periods presented.

Summarized financial information in the accompanying consolidated statements of operations for the discontinued eCOST operations is as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|-------------------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30 | |
| | 2011 | 2010 | 2011 | 2010 |
| Revenue, net | \$ 86 | \$ 16,057 | \$ 6,811 | \$ 36,082 |
| Expenses | 72 | 16,474 | 7,391 | 36,504 |
| Income (loss) before provision for income taxes | 14 | (417) | (580) | (422) |
| Provision for income taxes | | (23) | (9) | (24) |
| Discontinued operations, net of income taxes | \$ 14 | \$ (440) | \$ (589) | \$ (446) |

Summarized financial information in the accompanying consolidated balance sheet for the discontinued eCOST operations, which were sold in February 2011, is as follows (in thousands):

| | December 31, 2010 |
|-----------------------------------|--------------------------|
| Inventories, net | \$ 2,776 |
| Identifiable intangibles | 316 |
| Goodwill | 810 |
| Assets of discontinued operations | \$ 3,902 |

At December 31, 2010, the amount of allowance for slow moving inventory included in discontinued operations was \$0.2 million.

The original eCOST acquisition resulted in a purchase price in excess of the fair value of net identifiable assets acquired and liabilities assumed. This excess purchase price was allocated to goodwill. Goodwill, which is not

deductible for tax purposes, is not amortized yet is subject to an annual impairment test, using a fair-value-based approach. The remaining balance of goodwill, \$0.8 million as of December 31, 2010, was included in assets of discontinued operations.

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

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

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like seek, strive, believe, expect, anticipate, predict, potential, continue, will, may, could, intend, plan, target and estimate or similar words, we are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K for the year ended December 31, 2010, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

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

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

Table of Contents**Overview**

We are an international business process outsourcing provider of end-to-end eCommerce solutions. We provide these solutions to major brand name companies seeking to optimize their supply chain and to enhance their traditional and online business channels and initiatives. We derive our revenues from providing a broad range of services as we process individual business transactions on our clients' behalf using three different seller services financial models: 1) the Enablement model, 2) the Agent (or Flash) model and 3) the Retail model.

We refer to the standard PFS seller services financial model as the Enablement model. In this model, our clients own the inventory and are the merchants of record and engage us to provide various business outsourcing services in support of their business operations. We derive our service fee revenues from a broad range of service offerings that include digital marketing, eCommerce technologies, order management, customer care, logistics and fulfillment, financial management and professional consulting. We offer our services as an integrated solution, which enables our clients to outsource their complete infrastructure needs to a single source and to focus on their core competencies. Our distribution services are conducted at warehouses we lease or manage. We currently provide infrastructure and distribution solutions to clients that operate in a range of vertical markets, including technology manufacturing, computer products, cosmetics, fragile goods, contemporary home furnishings, apparel, aviation, telecommunications, consumer electronics and consumer packaged goods, among others.

In this model, we typically charge for our services on a cost-plus basis, a percent of shipped revenue basis or a per-transaction basis, such as a per-minute basis for web-enabled customer contact center services and a per-item basis for fulfillment services. Additional fees are billed for other services. We price our services based on a variety of factors, including the depth and complexity of the services provided, the amount of capital expenditures or systems customization required, the length of contract and other factors.

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

As an additional service, we offer our second model, the Agent, or Flash, financial model, in which our clients maintain ownership of the product inventory stored at our locations as in the Enablement model. When a customer orders the product from our clients, a flash sale transaction passes product ownership to us for each order and we, in turn, immediately re-sell the product to the customer. The flash ownership exchange establishes us as the merchant of record, which enables us to use our existing merchant infrastructure to process sales to end customers, removing the need for the clients to establish these business processes internally, but permitting them to control the sales process to end customers. In this model, based on the terms of our current client arrangements, we record product revenue on a net basis.

Finally, our Retail model allows us to purchase inventory from the client just as any other client reseller partner. In this model, we place the initial and replenishment purchase orders with the client and take ownership of the product upon delivery to our facility. Consequently, in this model, we generate product revenue as we own the inventory and the accounts receivable arising from our product sales. Under the Retail model, depending upon the product category and sales characteristics, we may require the client to provide product price protection as well as product purchase payment terms, right of return, and obsolescence protection appropriate to the product sales profile. In this model we recognize product revenue for customer sales. Freight costs billed to customers are reflected as components of product revenue. This business model requires significant working capital requirements, for which we have credit available either through credit terms provided by our client or under senior credit facilities.

In general, we provide the Enablement model through our PFS and Supplies Distributors subsidiaries, the Agent or Flash model through our PFS and Supplies Distributors subsidiaries and the Retail model

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through our Supplies Distributors subsidiaries and our Retail Connect subsidiary. In connection with the sale of certain of the assets of eCOST.com (eCOST), the name of eCOST was changed to PFSweb Retail Connect, Inc., in March 2011.

Growth is a key element to achieving our future goals, including achieving and maintaining sustainable profitability. Growth in our Enablement and Agent models is driven by two main elements: new client relationships and organic growth from existing clients. We focus our sales efforts on larger contracts with brand-name companies within two primary target markets, online brands and retailers and technology manufacturers, which, by nature, require a longer duration to close but also have the potential to be higher-quality and longer duration engagements.

Growth within our Retail model is currently primarily driven by our ability to attract new master distributor arrangements with IPS or other manufacturers and the sales and marketing efforts of the manufacturers and third party sales partners.

We continue to monitor and control our costs to focus on profitability. While we are targeting our new service fee contracts to yield incremental gross profit, we also expect to incur incremental investments in technology development, operational and support management and sales and marketing expenses.

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

Cost of product revenues consists of the purchase price of product sold and freight costs, which are reduced by certain reimbursable expenses. These reimbursable expenses include pass-through customer marketing programs, direct costs incurred in passing on any price decreases offered by vendors to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and certain other expenses as defined under the master distributor agreements.

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

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

Selling, General and Administrative expenses consist of expenses such as compensation and related expenses for sales and marketing staff, distribution costs (excluding freight) applicable to the Supplies Distributors business and the Retail model, executive, management and administrative personnel and other overhead costs, including certain occupancy and information technology costs and depreciation and amortization expenses.

Monitoring and controlling our available cash balances and our expenses continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. To aid this, in May 2010, we completed a public offering of 2.3 million shares of our common stock that provided net proceeds of \$7.3 million.

Table of Contents**Results of Operations****For the Interim Periods Ended June 30, 2011 and 2010**

The results of operations related to the eCOST business unit that was sold in February 2011 have been reported as discontinued operations for all periods presented below. The following table discloses certain financial information for the periods presented, expressed in terms of dollars, dollar change, percentage change and as a percentage of total revenue (in millions):

| | Three Months Ended June 30, | | | | | Six Months Ended June 30, | | | | |
|-----------------------------------------------------|-----------------------------|-------------|------------|-------------------|---------------|---------------------------|--------------|--------------|-------------------|---------------|
| | 2011 | 2010 | Change | % of Net Revenues | | 2011 | 2010 | Change | % of Net Revenues | |
| Revenues: | | | | | | | | | | |
| Product revenue, net | \$ 38.8 | \$ 43.6 | \$ (4.8) | 57.1% | 65.7% | \$ 84.1 | \$ 89.3 | \$ (5.2) | 59.9% | 66.3% |
| Service fee revenue | 21.0 | 16.6 | 4.4 | 30.8% | 25.0% | 39.9 | 32.5 | 7.4 | 28.4% | 24.2% |
| Pass-through revenue | 8.2 | 6.2 | 2.0 | 12.1% | 9.3% | 16.4 | 12.8 | 3.6 | 11.7% | 9.5% |
| Total net revenues | 68.0 | 66.4 | 1.6 | 100.0% | 100.0% | 140.4 | 134.6 | 5.8 | 100.0% | 100.0% |
| Cost of Revenues | | | | | | | | | | |
| Cost of product revenue (1) | 35.4 | 40.6 | (5.2) | 91.3% | 93.1% | 77.9 | 83.0 | (5.1) | 92.6% | 93.0% |
| Cost of service fee revenue (2) | 15.8 | 12.0 | 3.8 | 75.3% | 72.4% | 29.6 | 23.4 | 6.2 | 74.2% | 72.0% |
| Pass-through cost of revenue (3) | 8.2 | 6.2 | 2.0 | 100.0% | 100.0% | 16.4 | 12.8 | 3.6 | 100.0% | 100.0% |
| Total cost of revenues | 59.4 | 58.8 | 0.6 | 87.4% | 88.5% | 123.9 | 119.2 | 4.7 | 88.2% | 88.6% |
| Product revenue gross profit | 3.4 | 3.0 | 0.4 | 8.7% | 6.9% | 6.2 | 6.3 | (0.1) | 7.4% | 7.0% |
| Service fee gross profit | 5.2 | 4.6 | 0.6 | 24.7% | 27.6% | 10.3 | 9.1 | 1.2 | 25.8% | 28.0% |
| Pass-through gross profit | | | | % | % | | | | % | % |
| Total gross profit | 8.6 | 7.6 | 1.0 | 12.6% | 11.5% | 16.5 | 15.4 | 1.1 | 11.8% | 11.4% |
| Selling, General and Administrative expenses | 9.4 | 8.4 | 1.0 | 13.9% | 12.6% | 18.7 | 17.0 | 1.7 | 13.4% | 12.6% |

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| | | | | | | | | | | |
|--------------------------------------------------------|----------|----------|--------|--------|--------|----------|----------|----------|--------|--------|
| Loss from operations | (0.8) | (0.8) | | (1.3)% | (1.1)% | (2.2) | (1.6) | (0.6) | (1.6)% | (1.2)% |
| Interest expense, net | 0.3 | 0.2 | 0.1 | 0.4% | 0.4% | 0.5 | 0.5 | | 0.3% | 0.4% |
| Loss from continuing operations before income taxes | (1.1) | (1.0) | (0.1) | (1.7)% | (1.5)% | (2.7) | (2.1) | (0.6) | (1.9)% | (1.6)% |
| Income tax expense, net | 0.1 | 0.1 | | 0.1% | (0.1)% | 0.2 | 0.2 | | 0.2% | 0.1% |
| Loss from continuing operations | (1.2) | (1.1) | (0.1) | (1.8)% | (1.6)% | (2.9) | (2.3) | (0.6) | (2.1)% | (1.7)% |
| Income (loss) from discontinued operations, net of tax | | (0.4) | 0.4 | 0.0% | (1.1)% | (0.6) | (0.4) | (0.2) | (0.4)% | (0.5)% |
| Net loss | \$ (1.2) | \$ (1.5) | \$ 0.3 | (1.8)% | (2.7)% | \$ (3.5) | \$ (2.7) | \$ (0.8) | (2.5)% | (2.2)% |

(1) % of net revenues represents the percent of Product revenue, net.

(2) % of net revenues represents the percent of Service fee revenue.

(3) % of net revenues represents the percent of Pass-through revenue.

Product Revenue, net. Product revenue of \$38.8 million in the three months ended June 30, 2011 decreased \$4.8 million or 11.1% as compared to the same quarter of the prior year. Product revenue in the six months ended June 30, 2011 decreased \$5.2 million to \$84.1 million or 5.8% compared to the six months ended June 30, 2010. The decrease was primarily due to the impact of lower sales volume, partially offset by increased unit pricing on certain products and the impact of euro currency conversion rates. We currently expect the remaining 2011 annual product revenue to remain relatively stable or decline modestly as compared to 2010 levels.

Service Fee Revenue. Service fee revenue of \$21.0 million increased \$4.4 million, or 26.6%, in the three months ended June 30, 2011 as compared to the same quarter of the prior year. Service fee revenue in the six months ended June 30, 2011 increased \$7.4 million to \$39.9 million or 22.5% compared to the six months in the prior year period. The increase in service fee revenue for the three and six months ended

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June 30, 2011 is primarily due to increased service fees from existing client relationships along with service fees from new client relationships that began in late 2010 and early 2011 partially offset by the impact of terminated clients.

The change in service fee revenue is shown below (\$ millions):

| | Three Months | Six Months |
|-------------------------------------------------|-----------------|---------------|
| Period ended June 30, 2010 | \$ 16.6 | \$ 32.5 |
| New service contract relationships | 4.2 | 6.8 |
| Change in existing client service fees | 2.9 | 5.5 |
| Terminated clients not included in 2011 revenue | (2.7) | (4.9) |
| Period ended June 30, 2011 | \$ 21.0 | \$ 39.9 |

Cost of Product Revenue. The cost of product revenue decreased by \$5.2 million, or 12.8%, to \$35.4 million in the three months ended June 30, 2011. The resulting gross profit margin was \$3.4 million, or 8.7% of product revenue, for the three months ended June 30, 2011 and \$3.0 million, or 6.9% of product revenue, for the comparable 2010 period. The cost of product revenue in the six months ended June 30, 2011 decreased \$5.1 million or 6.2% compared to the six month ended June 30, 2010. The gross profit margin was \$6.2 million, or 7.4% in the six months ended June 30, 2011 compared to \$6.3 million, or 7.0% in the same period of the prior year. The three and six month periods ended June 30, 2011 and 2010 include the impact of certain incremental gross margin earned on product sales resulting from certain product price increases and the impact of certain incremental inventory cost reductions.

Cost of Service Fee Revenue. Gross profit as a percentage of service fees was 24.7% in three month period ended June 30, 2011 and 27.6% in the same period of 2010. Gross profit as a percentage of service fees in the six months ended June 30, 2011 and 2010 was 25.8% and 28.0%, respectively. The gross profit percentage decrease is primarily due to a change in the client mix as well as lower gross margins on certain new contracts, including certain start up costs. The margin in the prior year period includes the benefit of certain higher margin incremental project work.

We target to earn an overall average gross profit of 25-30% on existing and new service fee contracts, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors including projected volumes.

Selling, General and Administrative Expenses. Selling, General and Administrative expenses for the three months ended June 30, 2011 and 2010 were \$9.4 million and \$8.4 million, respectively. In the six months ended June 30, 2011 and 2010 selling, general and administrative expenses were \$18.7 million and \$17.0 million, respectively. As a percentage of total net revenue, selling, general and administrative expenses were 13.9% in the three months ended June 30, 2011 and 12.6% in the prior year period. Selling, general and administrative expenses were 13.3% and 12.6% in the six months ended June 30, 2011 and 2010, respectively. The increase in costs is primarily attributable to increased non-cash stock compensation expense, sales and marketing costs, personnel related expense, facility costs as well as growth in technology related costs required to support current and future growth.

Income Taxes. We record a tax provision associated primarily with state income taxes and our subsidiary Supplies Distributors Canadian and European operations as well as our Philippines operations. A valuation allowance has been provided for the majority of our net deferred tax assets, which are primarily related to our net operating loss carryforwards and certain foreign deferred tax assets. We expect we will continue to record an income tax provision associated with state income taxes and Supplies Distributors Canadian and European results of operations as well as our Philippines operations.

Income (Loss) from Discontinued Operations, Net of Tax. Discontinued operations generated income of approximately \$14,000 in the three months ended June 30, 2011 and a loss of \$0.4 million in the three months ended June 30, 2010. A loss from discontinued operations of \$0.6 million and \$0.4 million was generated in the six months ended June 30, 2011 and 2010, respectively. In February 2011, we sold substantially all of the inventory and certain intangible assets applicable to our eCOST business unit for a total aggregate cash purchase price of approximately \$2.3 million. For each of the three and six month

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periods ending June 30, 2011 and 2010, we have classified the operating results of this business unit, excluding costs expected to continue to occur in the future, as discontinued operations.

Liquidity and Capital Resources

During the six months ended June 30, 2011 we generated \$2.3 million in proceeds from the sale of our eCOST business in February 2011 plus \$1.3 million applicable to a reduction of eCOST inventory prior to the sale. In addition, we generated \$5.0 million applicable to a decrease in accounts receivable related to cash collected from our clients and customers following the December 31 seasonal peak period of our services business, and including \$0.9 million from eCOST customers following the February 2011 sales of that business. We also received proceeds from the issuance of common stock of \$1.6 million, primarily through the exercise of stock options. These cash inflows were partially offset by a decrease in accounts payable, deferred revenue, accrued expenses and other liabilities of \$5.4 million following the timing of payments we make for products and services, payment processing and related transaction costs, due to the impact of our December 31 seasonal peak period, but also including \$4.6 million applicable to the eCOST business following the February 2011 sale of that business. In addition, we experienced an increase in inventories of \$2.5 million, which is expected to be a temporary increase, related to the timing of product receipts.

Our principal sources of cash in the six months ended June 30, 2010 were \$7.3 million in proceeds from the issuance of common stock pursuant to a public offering and a \$3.0 million reduction in accounts receivable related to the collection of cash from our customers and clients following the December 31 seasonal peak.

We incurred capital expenditures of \$4.0 million and \$1.9 million in the six months ended June 30, 2011 and 2010, respectively and primarily consist of internally developed software, distribution equipment, leasehold improvements, and furniture and fixtures. Payments on capital leases and net payments on debt were \$1.0 million and \$4.0 million in the aggregate during the six months ended June 30, 2011 and 2010, respectively.

Capital expenditures have historically consisted of additions to upgrade our management information systems, development of customized technology solutions to support and integrate with our service fee clients, and general expansion and upgrades to our facilities, both domestic and foreign. We expect to incur capital expenditures to support new contracts and anticipated future growth opportunities. Based on our current client business activity and our targeted growth plans, we anticipate our total investment in upgrades and additions to facilities and information technology services for the upcoming twelve months, including costs to implement new clients, will be approximately \$6 million to \$9 million, although additional capital expenditures may be necessary to support the infrastructure requirements of new clients. To maintain our current operating cash position, a portion of these expenditures may be financed through client reimbursements, debt, operating or capital leases or additional equity. We may elect to modify or defer a portion of such anticipated investments in the event we do not obtain the financing or achieve the financial results necessary to support such investments.

During the six months ended June 30, 2011, our working capital decreased to \$21.1 million from \$22.6 million at December 31, 2010 primarily due to paydown of debt facilities and capital expenditures, partially offset by cash proceeds from our sale of certain intangible assets applicable to the eCOST.com business unit and proceeds from issuance of common stock related to stock option exercises. To obtain additional financing in the future, in addition to our current cash position, we plan to evaluate various financing alternatives including the sale of equity, utilizing capital or operating leases, borrowing under our credit facilities, expanding our current credit facilities or entering into new debt agreements. In conjunction with certain of these alternatives, we may be required to provide certain letters of credit to secure these arrangements. No assurances can be given we will be successful in obtaining any additional financing or the terms thereof. We currently believe our cash position, financing available under our credit facilities and funds generated from operations will satisfy our presently known operating cash needs, our working capital and capital expenditure requirements, our current debt and lease obligations, and additional loans to our subsidiaries, if necessary, for at least the next twelve months.

During the past few years, the credit markets and the financial services industry have been experiencing a period of unprecedented turmoil and upheaval characterized by the bankruptcy, failure, collapse or sale of various financial institutions and an unprecedented level of intervention from the United States and foreign governments. While the ultimate outcome of these events cannot be predicted, they may have a

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material adverse effect on our liquidity, financial condition, results of operations and our ability to renew our credit facilities.

In support of certain debt instruments and leases, as of June 30, 2011, we had \$1.3 million of cash restricted for repayment to lenders. In addition, as described above, we have provided collateralized guarantees to secure the repayment of certain of our subsidiaries' credit facilities. Many of these facilities include both financial and non-financial covenants, and also include cross default provisions applicable to other credit facilities and agreements. These covenants include minimum levels of net worth for the individual borrower subsidiaries and restrictions on the ability of the borrower subsidiaries to advance funds to other borrower subsidiaries. As a result, it is possible for one or more of these borrower subsidiaries to fail to meet their respective covenants even if another borrower subsidiary otherwise has available excess funds, which, if not restricted, could be used to cure the default. To the extent we fail to comply with our debt covenants, including the monthly financial covenant requirements and our required level of shareholders' equity, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. In particular, if PFS service fee revenue declines from expected levels and it is unable to reduce costs to correspond to such reduced revenue levels or if Supplies Distributors revenue or gross profit declines from expected levels, such events may result in a breach of one or more of the financial covenants required under their working capital lines 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 payment under our Company parent guarantee. A requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of June 30, 2011, we were in compliance with all debt covenants. Further, any non-renewal of any of our credit facilities would have a material adverse impact on our business and financial condition. We do not have any other material financial commitments, although future client contracts may require capital expenditures and lease commitments to support the services provided to such clients.

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

We receive municipal tax abatements in certain locations. During 2004 we received notice from a municipality that we did not satisfy certain criteria necessary to maintain the abatements. In December 2006, we received notice that the municipal authority planned to make an adjustment to our tax abatement. We disputed the adjustment and such dispute has been settled with the municipality. However, the amount of additional property taxes to be assessed against us and the timing of the related payments has not been finalized. As of June 30, 2011, we believe we have adequately accrued for the expected assessment.

In April 2010, a sales employee of eCOST was charged with violating various federal criminal statutes in connection with the sales of eCOST products to certain customers, and approximately \$620,000 held in an eCOST deposit account was seized and turned over to the Office of the U.S. Attorney in connection with such activity. We received subpoenas from the Office of the U.S. Attorney requesting information regarding the employee and other matters, and have responded to such subpoenas and are fully cooperating with the Office of the U.S. Attorney. We have commenced our own investigation into the actions of the employee. Neither the Company nor eCOST have been charged with any criminal activity, and we intend to seek the recovery or reimbursement of the funds, which are currently classified as other receivables in the June 30, 2011 financial statements. Based on the information available to date, we are unable to determine the amount of the loss, if any, relating to the seizure of such funds. No assurance can be given, however, that the seizure of such funds, or our inability to recover such funds or any significant portion thereof, or any costs and expenses we may incur in connection with such matter will not have a material adverse effect upon our financial condition or results of operations.

Table of Contents***Supplies Distributors Financing***

To finance their distribution of IPS products, Supplies Distributors and its subsidiaries have short-term credit facilities with IBM Credit LLC (IBM Credit) and IBM Belgium Financial Services S.A. (IBM Belgium). We have provided a collateralized guarantee to secure the repayment of these credit facilities. These asset-based credit facilities provided financing for up to \$25.0 million and up to 16 million euros (approximately \$23.0 million at June 30, 2011) with IBM Credit and IBM Belgium, respectively. These agreements expire in March 2012.

Supplies Distributors also has a loan and security agreement with Wells Fargo Bank, National Association (Wells Fargo) to provide financing for up to \$25 million of eligible accounts receivables in the United States and Canada. The Wells Fargo facility expires on the earlier of March 2014 or the date on which the parties to the IPS master distributor agreement no longer operate under the terms of such agreement and/or IPS no longer supplies products pursuant to such agreement.

Supplies Distributors European subsidiary has a factoring agreement with BNP Paribas Fortis to provide factoring for up to 7.5 million euros (approximately \$10.8 million as of June 30, 2011) of eligible accounts receivables through March 2014 as well as certain financial covenants, including minimum tangible net worth.

These credit facilities contain cross default provisions, various restrictions upon the ability of Supplies Distributors and its subsidiaries to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to related parties (including other direct or indirect Company subsidiaries), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as cash flow from operations, annualized revenue to working capital, net profit after tax to revenue, minimum net worth and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guarantees by their respective parent companies including Supplies Distributors and/or PFS and a Company parent guarantee. Additionally, we are required to maintain a subordinated loan to Supplies Distributors of no less than \$3.5 million, not maintain restricted cash of more than \$5.0 million, are restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure and a minimum shareholders equity of at least \$18.0 million. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors or its subsidiaries under these facilities if they are unable to do so. We have also provided a guarantee of the obligations of Supplies Distributors and its subsidiaries to IBM and IPS, excluding the trade payables that are financed by IBM credit.

PFS Financing

PFS has a Loan and Security Agreement (Agreement) with Comerica Bank (Comerica), which provides for up to \$10.0 million of eligible accounts receivable financing through September 2012. The Agreement allows for up to \$12.5 million of eligible accounts receivable financing during certain seasonal peak months. We entered this Agreement to supplement our existing cash position, and provide funding for our current and future operations, including our targeted growth. The Agreement contains cross default provisions, various restrictions upon our ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to subsidiaries, affiliates and related parties (including other direct or indirect Company subsidiaries), 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 \$20.0 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 Agreement also limits PFS ability to increase the subordinated loan to Supplies Distributors to more than \$5.0 million and permits PFS to advance incremental amounts subject to certain cash inflows to PFS, as defined, to certain of its subsidiaries and/or affiliates. The Agreement is secured by all of the assets of PFS, as well as a Company parent guarantee.

PFS financed certain capital expenditures through a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) pursuant to which the MBFC issued MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned PFS the proceeds of the Bonds for the purpose of financing the acquisition

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and installation of equipment, machinery and related assets to support incremental business from a Southaven, Mississippi distribution facility. The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) 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 2012. The amount outstanding on this Loan Agreement as of June 30, 2011 was \$0.8 million, the payment of which is due in January 2012. PFS obligations under the Reimbursement Agreement are secured by substantially all of its assets, including restricted cash of \$0.1 million, and a Company parent guarantee.

Retail Connect Financing

Retail Connect has an asset-based line of credit facility of up to \$7.5 million with Wachovia Bank N.A. (Wachovia), which is collateralized by substantially all of Retail Connect s assets and expires in May 2012. Borrowings under the facility are limited to a percentage of accounts receivable and inventory, up to specified maximums. As of June 30, 2011, Retail Connect had \$0.1 million of letters of credit outstanding and \$0.1 million of available credit under this facility. Amounts available under the outstanding letters of credit are currently secured by restricted cash in equivalent amounts. The credit facility restricts Retail Connect s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as a minimum tangible net worth of \$0 million, as defined. The Company has guaranteed all current and future obligations of Retail Connect under this line of credit.

In February 2011, we sold substantially all of the inventory and certain intangible assets of eCOST for a cash purchase price of \$2.3 million (before expenses of approximately \$0.2 million) and the assumption by the purchases of certain limited liabilities of eCOST. In connection with the closing of this business unit, we incurred exit costs of approximately \$0.3 million related to employee termination costs, excess property and equipment and contract termination costs and may incur additional costs, including excess facility costs. During 2010, we recorded a non-cash goodwill impairment charge of approximately \$2.8 million.

Public Offering

In May 2010, we completed a public offering of our common stock pursuant to which we issued and sold an aggregate of 2.3 million shares of our common stock, par value \$.001 per share, at \$3.50 per share, resulting in net proceeds after deducting offering expenses of approximately \$7.3 million.

Seasonality

The seasonality of our service fee business is dependent upon the seasonality of our clients business and sales of their products. Accordingly, we must rely upon the projections of our clients in assessing quarterly variability. We believe that with our current client mix and their current business volumes, our run rate service fee business activity will be at its lowest in the quarter ended March 31 and highest in the quarter ended December 31. We anticipate our product revenue will be highest during the quarter ended December 31. We believe our historical revenue pattern makes it difficult to predict the effect of seasonality on our future revenues and results of operations.

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

Inflation

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

Critical Accounting Policies

A description of our critical accounting policies is included in Note 2 of the consolidated financial statements in our December 31, 2010 Annual Report on Form 10-K.

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ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Not required.

ITEM 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain a comprehensive set of disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. As of June 30, 2011, an evaluation of the effectiveness of our disclosure controls and procedures was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, these disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

During the period that ended on June 30, 2011, there was no change in internal control over financial reporting (as defined in Rule 13a-15(f) or Rule 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1. Legal Proceedings**

None

ITEM 1A. Risk Factors

In addition to the risk factors set forth in Part I, Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010 filed with the Securities and Exchange Commission on March 31, 2011, our business, financial condition and operating results could be adversely affected by any or all of the following factors.

General Risks Related to Our Business

Our business and future growth depend on our continued access to bank and commercial financing. An uncertain or recessed economy may negatively impact our business, results of operations, financial condition or liquidity.

During the past several years, the credit markets and the financial services industry have been experiencing a period of unprecedented turmoil and upheaval characterized by the bankruptcy, failure, collapse or sale of various financial institutions and an unprecedented level of intervention from the United States and foreign governments. An uncertain or recessed economy could also adversely impact our customers' operations or ability to maintain liquidity which may negatively impact our business and results of operations.

Our business and future growth currently depend on our ability to access bank and commercial lines of credit. We currently depend on an aggregate of approximately \$103.7 million in line of credit facilities provided by various banks and commercial lenders. These lines of credit currently mature at various dates through March 2014 and are secured by substantially all our assets. Our ability to renew our line of credit facilities depends upon various factors, including the availability of bank loans and commercial credit in general, as well as our financial condition and prospects. Therefore, we cannot guarantee that these credit facilities will continue to be available beyond their current maturities on reasonable terms or at all. Our inability to renew or replace our credit facilities or find alternative financing would materially adversely affect our business, financial condition, operating results and cash flow.

We operate with significant levels of indebtedness and are required to comply with certain financial and non-financial covenants; we are required to maintain a minimum level of subordinated loans to our subsidiary Supplies Distributors; and we have guaranteed certain indebtedness and obligations of our subsidiaries Supplies Distributors and Retail Connect.

As of June 30, 2011, our total credit facilities outstanding, including debt, capital lease obligations and our vendor accounts payable related to financing of IPS product inventory, was approximately \$56.2 million. Certain of the credit facilities have maturity dates in calendar year 2012 or beyond, but are classified as current liabilities in our consolidated financial statements given the underlying nature of the credit facility. We cannot provide assurance that our credit facilities will be renewed by the lending parties. Additionally, these credit facilities include both financial and non-financial covenants, many of which also include cross default provisions applicable to other agreements. These covenants also restrict our ability to transfer funds among our various subsidiaries, which may adversely affect the ability of our subsidiaries to operate their businesses or comply with their respective loan covenants. We cannot provide assurance that we will be able to maintain compliance with these covenants. Any non-renewal or any default under any of our credit facilities would have a material adverse impact upon our business and financial condition. In addition we have provided \$4.3 million of subordinated indebtedness to Supplies Distributors as of June 30, 2011. The maximum level of this subordinated indebtedness to Supplies Distributors that may be provided without approval from our lenders is \$5.0 million. The restrictions on increasing this amount without lender approval may limit our ability to comply with certain loan covenants or further grow and develop Supplies Distributors' business. We have guaranteed most of the indebtedness of Supplies Distributors. Furthermore, we are obligated to repay any over-advance made to Supplies

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Distributors by its lenders to the extent Supplies Distributors is unable to do so. We have also guaranteed Retail Connect's \$7.5 million credit line, as well as certain of its vendor trade payables.

Specific Risks Related to Our Business Process Outsourcing Business

Our business is subject to the risk of customer and supplier concentration.

For the six months ended June 30, 2011, two clients represented approximately 28% of our total service fee revenue (excluding pass-through revenue) and approximately 9% of our total consolidated revenue. The loss of either of these clients may have a material adverse effect upon our business and financial condition.

The majority of our Supplies Distributors product revenue is generated by sales of product purchased under master distributor agreements with IPS. These agreements are terminable at will and no assurance can be given that IPS will continue the master distributor agreements with Supplies Distributors. 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 product. Discontinuance of such activities would have a material adverse effect on Supplies Distributors' business and our overall financial condition.

Sales by Supplies Distributors to two customers in the aggregate accounted for approximately 26% of Supplies Distributors' total product revenue for the six months ended June 30, 2011, (16% of our consolidated net revenues in the six month period ended June 30, 2011). The loss of any one or both of such customers, or non-payment of any material amount by these or any other customer, would have a material adverse effect upon Supplies Distributors' business.

Risks Related to Our Stock

Our stock price could decline if a significant number of shares become available for sale.

As of June 30, 2011, we have an aggregate of 2.4 million stock options outstanding to employees, directors and others with a weighted average exercise price of \$4.51 per share. The shares of common stock that may be issued upon exercise of these options may be resold into the public market. Sales of substantial amounts of common stock in the public market as a result of the exercise of these options, or the perception that future sales of these shares could occur, could reduce the market price of our common stock and make it more difficult to sell equity securities in the future.

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

None

ITEM 3. Defaults Upon Senior Securities

None

ITEM 4. [Removed and Reserved]**ITEM 5. Other Information**

None

ITEM 6. Exhibits and Reports on Form 8-K

a) Exhibits:

Exhibit

| No. | Description of Exhibits |
|------------|-----------------------------------------------------------------------------------------------|
| 3.1(1) | Amended and Restated Certificate of Incorporation of PFSweb, Inc. |
| 3.1.1(2) | Certificate of Amendment to Amended and Restated Certificate of Incorporation of PFSweb, Inc. |
| 3.1.2(4) | Certificate of Amendment to Certificate of Incorporation of PFSweb, Inc. |

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Exhibit

| No. | Description of Exhibits |
|------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1.3(5) | Certificate of Amendment to Amended and Restated Certificate of Incorporation of PFSweb, Inc. |
| 3.2(1) | Amended and Restated By-Laws |
| 3.2.1(3) | Amendment to the Amended and Restated By-Laws of PFSweb, Inc. |
| 3.2.2(6) | Amendment to the Amended and Restated By-Laws of PFSweb, Inc. |
| 10.1* | Seventh Amendment to Loan and Security Agreement dated January 6, 2009 by and between Wells Fargo Bank, National Association and PFSweb Retail Connect, Inc. |
| 31.1* | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS** | XBRL Instance Document. |
| 101.SCH** | XBRL Taxonomy Extension Schema. |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase. |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase. |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase. |
| (1) | Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657). |
| (2) | Incorporated by reference from PFSweb, Inc. Form 10-K for the fiscal year ended December, 31, 2005 filed on March 31, 2006. |
| (3) | Incorporated by reference from PFSweb, Inc. Report on Form 8-K filed on November 13, 2007. |
| (4) | Incorporated by reference from PFSweb, Inc. Report on Form 8-K filed on June 2, 2008. |
| (5) | Incorporated by reference from PFSweb, Inc. Form 10-Q filed on August 14, 2009. |
| (6) | Incorporated by reference from PFSweb, Inc. Report on Form 8-K filed on July 2, 2010. |

* Filed Herewith

** Furnished Herewith

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SIGNATURE

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

Date: August 15, 2011

PFSweb, Inc.

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

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