

LIQUIDITY SERVICES INC
Form 10-Q
May 09, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2008

OR

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

For the transition period from to

Commission file number 0-51813

LIQUIDITY SERVICES, INC.

(Exact Name of Registrant as Specified in Its Charter)

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Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

52-2209244
(I.R.S. Employer
Identification No.)

1920 L Street, N.W., 6th Floor, Washington, D.C.
(Address of Principal Executive Offices)

20036
(Zip Code)

(202) 467-6868

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The number of shares outstanding of the issuer's common stock, par value \$.001 per share, as of May 9, 2008 was 27,963,195.

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PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements.

Liquidity Services, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in Thousands)

| | March 31, 2008 (Unaudited) | September 30, 2007 |
|--|----------------------------------|-----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 40,444 | \$ 39,954 |
| Short-term investments | 21,992 | 21,655 |
| Accounts receivable, net of allowance for doubtful accounts of \$296 and \$371 at March 31, 2008 and September 30, 2007, respectively | 3,625 | 5,098 |
| Inventory | 16,760 | 16,467 |
| Prepaid expenses and other current assets | 7,043 | 5,486 |
| Total current assets | 89,864 | 88,660 |
| Property and equipment, net | 4,402 | 4,202 |
| Intangible assets, net | 5,143 | 4,568 |
| Goodwill | 19,752 | 11,446 |
| Other assets | 2,775 | 2,266 |
| Total assets | \$ 121,936 | \$ 111,142 |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 5,530 | \$ 3,333 |
| Accrued expenses and other current liabilities | 5,729 | 10,299 |
| Profit-sharing distributions payable | 9,510 | 6,919 |
| Customer payables | 9,220 | 6,329 |
| Current portion of capital lease obligations | 3 | 5 |
| Current portion of long-term debt | | 13 |
| Total current liabilities | 29,992 | 26,898 |
| Capital lease obligations, net of current portion | 4 | 5 |
| Long-term debt, net of current portion | | 29 |
| Other long-term liabilities | 2,673 | 2,176 |
| Total liabilities | 32,669 | 29,108 |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value; 120,000,000 shares authorized; 27,961,320 and 27,939,059 shares issued and outstanding at March 31, 2008 and September 30, 2007, respectively | 28 | 28 |
| Additional paid-in capital | 63,180 | 60,820 |
| Accumulated other comprehensive income | 517 | 653 |
| Retained earnings | 25,542 | 20,533 |
| Total stockholders' equity | 89,267 | 82,034 |
| Total liabilities and stockholders' equity | \$ 121,936 | \$ 111,142 |

See accompanying notes to the unaudited consolidated financial statements.

Liquidity Services, Inc. and Subsidiaries

Unaudited Consolidated Statements of Operations

(Dollars in Thousands Except Per Share Data)

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|------------------------------|------------|----------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenue | \$ 62,839 | \$ 49,281 | \$ 122,105 | \$ 94,448 |
| Costs and expenses: | | | | |
| Cost of goods sold (excluding amortization) | 16,162 | 11,539 | 31,565 | 20,001 |
| Profit-sharing distributions | 22,630 | 17,890 | 43,436 | 36,619 |
| Technology and operations | 10,300 | 8,397 | 20,277 | 16,238 |
| Sales and marketing | 3,917 | 3,225 | 8,050 | 6,189 |
| General and administrative | 5,275 | 4,049 | 10,114 | 7,487 |
| Amortization of contract intangibles | 203 | 203 | 407 | 407 |
| Depreciation and amortization | 465 | 309 | 852 | 581 |
| Total costs and expenses | 58,952 | 45,612 | 114,701 | 87,522 |
| Income from operations | 3,887 | 3,669 | 7,404 | 6,926 |
| Interest income (expense) and other income, net | 621 | 551 | 1,109 | 1,149 |
| Income before provision for income taxes | 4,508 | 4,220 | 8,513 | 8,075 |
| Provision for income taxes | (1,862) | (1,746) | (3,504) | (3,288) |
| Net income | \$ 2,646 | \$ 2,474 | \$ 5,009 | \$ 4,787 |
| Basic earnings per common share | \$ 0.10 | \$ 0.09 | \$ 0.18 | \$ 0.17 |
| Diluted earnings per common share | \$ 0.10 | \$ 0.09 | \$ 0.18 | \$ 0.17 |
| Basic weighted average shares outstanding | 27,951,777 | 27,708,278 | 27,947,958 | 27,652,849 |
| Diluted weighted average shares outstanding | 28,261,121 | 28,526,789 | 28,184,407 | 28,463,064 |

See accompanying notes to the unaudited consolidated financial statements.

Liquidity Services, Inc. and Subsidiaries

Unaudited Consolidated Statements of Cash Flows

(In Thousands)

| | Six Months Ended March 31, | |
|---|----------------------------|-----------|
| | 2008 | 2007 |
| Operating activities | | |
| Net income | \$ 5,009 | \$ 4,787 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,259 | 988 |
| Stock compensation expense | 2,263 | 883 |
| Provision for doubtful accounts | (164) | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,991 | (1,230) |
| Inventory | (294) | (5,311) |
| Prepaid expenses and other assets | (1,819) | (3,032) |
| Accounts payable | 1,847 | 1,391 |
| Accrued expenses and other | (4,570) | (287) |
| Profit-sharing distributions payable | 2,591 | 2,656 |
| Customer payables | 2,892 | 961 |
| Other long-term liabilities | 73 | 1,048 |
| Net cash provided by operating activities | 11,078 | 2,854 |
| Investing activities | | |
| Purchases of short-term investments | (24,749) | (14,397) |
| Proceeds from the sale of short-term investments | 24,288 | 16,466 |
| Increase in goodwill and intangibles | (23) | (15) |
| Cash paid for acquisitions, net of cash acquired | (9,389) | (10,232) |
| Purchases of property and equipment | (754) | (1,668) |
| Net cash used in investing activities | (10,627) | (9,846) |
| Financing activities | | |
| Principal repayments of capital lease obligations and debt | (46) | (65) |
| Proceeds from exercise of common stock options and warrants (net of tax) | 93 | 489 |
| Incremental tax benefit from exercise of common stock options | 3 | 700 |
| Net proceeds from the issuance of common stock | | 1,328 |
| Net cash provided by financing activities | 50 | 2,452 |
| Effect of exchange rate differences on cash and cash equivalents | (11) | 147 |
| Net increase (decrease) in cash and cash equivalents | 490 | (4,393) |
| Cash and cash equivalents at beginning of the period | 39,954 | 54,359 |
| Cash and cash equivalents at end of period | \$ 40,444 | \$ 49,966 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for income taxes | \$ 7,139 | \$ 4,960 |
| Cash paid for interest | \$ 9 | \$ 3 |

See accompanying notes to the unaudited consolidated financial statements.

Liquidity Services, Inc. and Subsidiaries

Notes to the Unaudited Consolidated Financial Statements

1. Organization

Liquidity Services, Inc. and subsidiaries (LSI or the Company) is a leading online auction marketplace for wholesale, surplus and salvage assets. LSI enables buyers and sellers to transact in an efficient, automated online auction environment offering over 500 product categories. The Company's marketplaces provide professional buyers access to a global, organized supply of wholesale, surplus and salvage assets presented with digital images and other relevant product information. Additionally, LSI enables its corporate and government sellers to enhance their financial return on excess assets by providing a liquid marketplace and value-added services that integrate sales and marketing, logistics and transaction settlement into a single offering. LSI organizes its products into categories across major industry verticals such as consumer electronics, general merchandise, apparel, scientific equipment, aerospace parts and equipment, technology hardware, and specialty equipment. The Company's online auction marketplaces are www.liquidation.com, www.govliquidation.com, www.govdeals.com and www.liquibiz.com. LSI also operates a wholesale industry portal, www.goWholesale.com, that connects advertisers with buyers seeking products for resale and related business services.

2. Summary of Significant Accounting Policies

Unaudited Interim Financial Information

The accompanying unaudited consolidated balance sheet as of March 31, 2008, unaudited consolidated statements of operations for the three and six months ended March 31, 2008 and 2007 and the unaudited statements of cash flows for the six months ended March 31, 2008 and 2007 have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal, recurring adjustments, considered necessary for a fair presentation have been included. The information disclosed in the notes to the consolidated financial statements for these periods is unaudited. Operating results for the three and six months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending September 30, 2008 or any future period.

Short-Term Investments

Available-for-sale securities are stated at fair value, with the unrealized gains and losses reported in accumulated other comprehensive income. For the three- and six-months ended March 31, 2008 and 2007, the amount of unrealized losses and gains reported in accumulated other comprehensive income was \$94,000 and \$111,000 of loss, and \$27,000 and \$4,000 of gain, respectively.

Stock-Based Compensation

The Company accounts for stock-based compensation under Statement 123(R). The Company's income before provision for income taxes and net income for the three- and six-months ended March 31, 2008 and 2007 was approximately \$1,151,000 and \$679,000, and \$2,263,000 and \$1,335,000; and \$519,000 and \$306,000, and \$883,000 and \$521,000 lower, respectively, than if it had continued to account for share-based compensation under APB Opinion No. 25. The total compensation cost related to nonvested awards not yet recognized at March 31, 2008 was approximately \$13,113,000, which is being recognized over the weighted average vesting period of 33 months. The Company utilizes the Black-Scholes option pricing model to determine its Statement 123(R) expense. Inputs into the Black-Scholes model include volatility rates that ranged from 40% to 65%, dividend rate of 0%, and risk-free interest rates that ranged from 2.52% to 5.05% since October 1, 2005. The Company anticipates a forfeiture rate ranging from 11.4% to 33.4% based on its historical forfeiture rate. As a result of adopting Statement 123(R) on October 1, 2005, the Company's basic and diluted earnings per share for the three- and six-months ended March 31, 2008 and 2007 were approximately \$0.02 and \$0.02, and \$0.05 and \$0.05; and \$0.01 and \$0.01, and \$0.02 and \$0.02, respectively, lower than if it had continued to account for share-based compensation under APB Opinion No. 25.

Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

Earnings per Share

Basic net income attributable to common stockholders per share is computed by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net income attributable to common stockholders per share includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. We have not included the following stock options in our calculation of diluted income per share because the option exercise prices were greater than the average market prices for the applicable periods:

- (a) for the three months ended March 31, 2008, 3,124,244 options;
- (b) for the six months ended March 31, 2008, 2,647,985 options;
- (c) for the three months ended March 31, 2007, 3,000 options; and
- (d) for the six months ended March 31, 2007, 3,000 options.

The following summarizes the potential outstanding common stock of the Company as of the dates set forth below:

| | Three Months Ended March 31, 2008 | | 2007 (unaudited) | | Six Months Ended March 31, 2008 | | 2007 | |
|--|--|-------|---------------------|-------|------------------------------------|-------|------------|-------|
| | (dollars in thousands, except per share amounts) | | | | | | | |
| Weighted average shares calculation: | | | | | | | | |
| Basic weighted average shares outstanding | 27,951,777 | | 27,708,278 | | 27,947,958 | | 27,652,849 | |
| Treasury stock effect of options and warrants | 309,344 | | 818,511 | | 236,449 | | 810,215 | |
| Diluted weighted average common shares outstanding | 28,261,121 | | 28,526,789 | | 28,184,407 | | 28,463,064 | |
| Net income | \$ | 2,646 | \$ | 2,474 | \$ | 5,009 | \$ | 4,787 |
| Net income per common share: | | | | | | | | |
| Basic income per common share | \$ | 0.10 | \$ | 0.09 | \$ | 0.18 | \$ | 0.17 |
| Diluted income per common share | \$ | 0.10 | \$ | 0.09 | \$ | 0.18 | \$ | 0.17 |

3. Defense Reutilization and Marketing Service Contracts and U.K. Disposal Service Agency Contract

Defense Reutilization and Marketing Service (DRMS) Contracts

The Company's Surplus Contract (the Surplus Contract) with DRMS expires in June 2008. The Company is in the process of responding to a Request For Proposal (RFP) from the DRMS regarding a renewal of the Surplus Contract. Under the terms of the Surplus Contract, the Company acquires surplus government property from DRMS at a fixed percentage of the property's original estimated acquisition value. The Company is required to purchase all surplus government property referred to it by DRMS. The Company then markets the property through its buyer network. Under the terms of the contract, the Company distributes to DRMS a fixed percentage of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses and profit-sharing distributions, as provided for under the terms of the contract.

As a result of this contract, the Company is the sole remarketer of all U.S. Department of Defense (DoD) surplus turned into DRMS available for sale within the United States, Puerto Rico, and Guam.

The Company's Scrap Contract (the Scrap Contract) with DRMS expires in June 2012. Under the terms of the Scrap Contract, the Company is required to purchase all scrap government property referred to it by DRMS. As a result of this contract, the Company is the sole remarketer of all DoD scrap turned into DRMS available for sale within the United States, Puerto Rico, and Guam.

The contracts may be terminated by either the Company or DRMS if the rate of return performance ratio does not exceed specified benchmark ratios for two consecutive quarterly periods and the preceding twelve months. The Company has performed in excess of the benchmark ratios throughout the contract period through March 31, 2008.

Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

Based on the sales price of the inventory, after reduction for allowable expenses and other disbursements under the Surplus Contract with DRMS, the Company was required to disburse to DRMS 78.2%, and to Kormendi/Gardener Partners (KGP), 1.8% of the profits from the sale of goods under this contract. In addition, disbursements to DRMS/KGP are only required to the extent the Company has distributable cash surplus, as defined under the contract. This generally means that the Company is only required to disburse funds to the extent cash on hand at the Company's subsidiary, Government Liquidation.com (GL), exceeds the sum of outstanding working capital advances, management's estimated accrued liabilities, contingent liabilities, and estimated operating expenses for the upcoming month. On September 12, 2006, the DoD agreed to increase the profit-sharing distribution for the Surplus Contract in exchange for the Company's agreement to implement additional inventory assurance processes and procedures with respect to the sale of demilitarized property. From August 1, 2006 until November 30, 2006, the Company was entitled to receive 27.5% of the profits and DRMS was entitled to 72.5% of the profits from the sale of goods under this contract. Since November 30, 2006, the Company has been entitled to receive between 25% and 30.5% of the profits, based on the results of an audit of the effectiveness of the inventory controls the Company implements under the contract modification, which is referred to as the Surplus Contract incentive. This incentive will be measured quarterly during fiscal year 2008. On June 1, 2007, the Company agreed, as provided in the modification to the Surplus Contract that became effective as of September 12, 2006, to provide additional value-added services with respect to demilitarized property that is returned to the DoD for reutilization. In exchange for the agreement to provide these services, the DoD exercised its existing option to increase the Company's share of net proceeds under the Surplus Contract by 1%. Profit-sharing distributions to DRMS/KGP under the Surplus Contract for the three- and six-months ended March 31, 2008 and 2007 were \$11,066,000, \$19,621,000, \$7,231,000 and \$16,720,000, respectively, including accrued amounts, as of March 31, 2008 and 2007, of \$3,818,000 and \$2,589,000, respectively.

Under the original terms of the Scrap Contract, the Company was required to disburse to DRMS 78.2%, and to KGP 1.8% of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses, calculated in a similar manner to that of the Surplus Contract. Under the Scrap Contract, the Company also has a performance incentive that allows it to receive up to an additional 2% of the profit sharing distribution. This incentive is measured annually on June 30th, and is applied to the prior 12 months. On May 21, 2007, the DoD agreed to increase the profit-sharing distribution, to the Company under the Scrap Contract, from 20% to 23% effective June 1, 2007, in exchange for the Company's agreement to implement additional inventory assurance processes and procedures with respect to the mutilation of demilitarized scrap property sold by the Company. For the three- and six-months ended March 31, 2008 and 2007, profit-sharing distributions to the DRMS under the Scrap Contract amounted to \$11,238,000, \$22,959,000, \$9,530,000 and \$18,197,000, respectively, including accrued amounts, as of March 31, 2008 and 2007, of \$5,628,000 and \$7,739,000, respectively.

U.K. Disposal Services Agency (DSA) Contract

Under the contract with the DSA, the Company is required to disburse to DSA a percentage that varies based on the total annual sales volume. Distributions to DSA for the three- and six-months ended March 31, 2008 and 2007 were \$326,000, \$864,000, \$970,000 and \$1,544,000, respectively, including accrued amounts, as of March 31, 2008 and 2007, of \$64,000.

4. GovDeals Acquisition

On January 1, 2008, the Company acquired the stock of Information Management Specialists, Inc. and its GovDeals, Inc. subsidiary for approximately \$9,389,000 in cash net of acquired cash of \$742,000. GovDeals is an online auction marketplace for the sale of surplus and confiscated items for local and state government entities including city, county and state agencies as well as school boards and public utilities. The operating results of GovDeals have been included in the consolidated financial statements from the date of acquisition.

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Goodwill was created as part of the acquisition as the Company acquired an experienced and knowledgeable workforce, along with customer lists and non-contractual customer relationships. The purchase consideration was allocated to acquired tangible assets, identifiable intangible assets, liabilities assumed and goodwill as follows:

| | Consideration Amount (in thousands) |
|--|--|
| Goodwill | \$ 8,306 |
| Cash, receivables and other assets | 1,342 |
| Covenants not to compete, brand and technology intangibles | 1,095 |
| Property and equipment | 162 |
| Deferred tax liability | (423) |
| Other liabilities | (351) |
| Total consideration | \$ 10,131 |

Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

5. Intangible Assets

Intangible assets at March 31, 2008 consisted of the following:

| | Useful Life (in years) | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|------------------------------|------------------------------|-----------------------------|-----------------------------|---------------------------|
| (dollars in thousands) | | | | |
| Contract intangible | 7 | \$ 5,694 | \$ (2,169) | \$ 3,525 |
| Brand and technology | 5 | 575 | (29) | 546 |
| Covenants not to compete | 5 | 1,200 | (284) | 916 |
| Patent and trademarks | 3 - 10 | 175 | (19) | 156 |
| Total intangible assets, net | | | | \$ 5,143 |

Future expected amortization of intangible assets at March 31, 2008 was as follows:

| Years ending September 30, | (in thousands) |
|-----------------------------|----------------|
| 2008 (remaining six months) | \$ 598 |
| 2009 | 1,196 |
| 2010 | 1,182 |
| 2011 | 1,148 |
| 2012 and after | 1,019 |

6. Debt

Senior Credit Facility

In December 2002, and as subsequently amended, the Company entered into a senior credit facility (the Agreement) with a bank, which provides for borrowings up to \$30.0 million. This senior credit facility will expire in March 2010.

Borrowings under the Agreement bear interest at an annual rate equal to the LIBOR rate plus 1.5% (3.986% at March 31, 2008) due monthly. As of March 31, 2008 and September 30, 2007, the Company had no outstanding borrowings under the Agreement.

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Borrowings under the Agreement are secured by substantially all of the assets of the Company. The Agreement contains certain financial and non-financial restrictive covenants including, among others, the requirements to maintain a minimum level of earnings before interest, income taxes, depreciation and amortization (EBITDA). As of March 31, 2008, the Company was in compliance with these covenants.

Note Payable

Debt consisted of the following:

| | March 31, 2008 (unaudited) | September 30, 2007 |
|---|----------------------------------|-----------------------|
| | (in thousands) | |
| Note payable other | | \$ 48 |
| Less: unamortized debt discount | | (6) |
| Subtotal | | 42 |
| Less: current portion of long-term debt | | (13) |
| Long-term portion debt | | \$ 29 |

Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

7. Income Taxes

The Company's interim effective income tax rate is based on management's best current estimate of the expected annual effective income tax rate. Based on current projections of taxable income for the year ending September 30, 2008, the Company expects that it will have an effective income tax rate of 41%.

As of March 31, 2008, the Company's deferred tax assets exceeded its deferred tax liabilities. The Company had a net deferred tax asset of approximately \$3.2 million at March 31, 2008.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) on October 1, 2007. The adoption of FIN 48 did not impact the Company's financial position or results of operations. The Company has concluded that there were no uncertain tax positions identified during its analysis. The Company's policy is to recognize interest and penalties in the period in which they occur in the income tax provision. The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, various state and local jurisdictions and in foreign jurisdictions, primarily the UK and Germany. The Company is no longer subject to U.S. federal, state and local, or foreign income tax examinations by tax authorities for years before fiscal 2004, although carryforward of tax attributes that were generated prior to fiscal 2004 may still be adjusted upon examination by tax authorities if they are utilized.

The Company is not currently under audit for income taxes in any jurisdiction.

8. Stockholders Equity

Common Stock

On February 23, 2006, the Company issued 5,000,000 shares of common stock for net proceeds of \$43,977,000 in conjunction with its initial public offering. On March 13, 2007, the Company issued 100,000 shares of common stock for net proceeds of \$1,070,000 in conjunction with its follow-on offering.

2006 Omnibus Long-Term Incentive Plan (the 2006 Plan)

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5,000,000 shares of common stock were initially reserved for issuance under the 2006 Plan. During fiscal year 2006, the Company issued options to purchase 1,208,000 shares to employees and directors with exercise prices between \$12.89 and \$17.63 and options to purchase 97,000 shares were forfeited. At September 30, 2006, there were 3,889,000 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During fiscal year 2007, the Company issued options to purchase 497,585 shares to employees and directors with exercise prices between \$12.49 and \$20.88 and options to purchase 67,814 shares were forfeited. At September 30, 2007, there were 3,459,229 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During the six months ended March 31, 2008, the Company issued options to purchase 1,750,404 shares to employees and directors with exercise prices between \$10.63 and \$13.48, and options to purchase 138,220 shares were forfeited. At March 31, 2008, there were 1,847,045 shares remaining reserved for issuance in connection with awards under the 2006 Plan. The maximum number of shares subject to options or stock appreciation rights that can be awarded under the 2006 Plan to any person is 1,000,000 per year. The maximum number of shares that can be awarded under the 2006 Plan to any person, other than pursuant to an option or stock appreciation right, is 700,000 per year.

Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

Stock Option Activity

A summary of the Company's stock option activity for the year ended September 30, 2007 and the three months ended December 31, 2007 and March 31, 2008 is as follows:

| | Options | Weighted- Average Exercise Price |
|--|-----------|--|
| Options outstanding at September 30, 2006 | 1,990,196 | \$ 9.48 |
| Options granted | 497,585 | 16.83 |
| Options exercised | (254,451) | 4.07 |
| Options canceled | (82,359) | 12.07 |
| Options outstanding at September 30, 2007 | 2,150,971 | 11.72 |
| Options granted (unaudited) | 1,704,904 | 12.79 |
| Options exercised (unaudited) | (9,889) | 5.16 |
| Options canceled (unaudited) | (29,084) | 11.95 |
| Options outstanding at December 31, 2007 (unaudited) | 3,816,902 | 12.21 |
| Options granted (unaudited) | 45,500 | 12.63 |
| Options exercised (unaudited) | (12,372) | 3.41 |
| Options canceled (unaudited) | (119,117) | 13.32 |
| Options outstanding at March 31, 2008 (unaudited) | 3,730,913 | 12.21 |
| Options exercisable at March 31, 2008 (unaudited) | 1,121,791 | 10.39 |

The intrinsic value of outstanding and exercisable options at March 31, 2008 is approximately \$2,043,000 and \$1,471,000, respectively, based on a stock price of \$8.00 on March 31, 2008.

9. Contingencies

In January 2008, KGP commenced litigation against GL and Surplus Acquisition Venture, LLC (SAV), one of the Company's other subsidiaries, seeking \$1.5 million in damages. KGP claims it is entitled to these damages because of actions GL and SAV took at the direction of DRMS pursuant to an amendment to our Surplus Contract entered into in August 2006. GL and SAV have filed a motion to dismiss this litigation in its entirety and believe they have meritorious defenses in this litigation. In addition, SAV and GL believe they likely would be able to recover their costs and damages arising out of this litigation from DRMS under the terms of the Surplus Contract.

10. Subsequent Event

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On May 1, 2008, the Company acquired the companies in the Geneva Group, including Geneva Industries Ltd., Willen Trading Ltd., and Geneva Auctions Ltd., for approximately \$17.2 million in cash and contingent earn-out payments of up to an aggregate of approximately \$2.9 million payable over the next three years. The Geneva Group is a leading United Kingdom (UK) based remarketer of reverse supply chain merchandise, including customer returns and overstock merchandise.

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

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements. These statements are only predictions. The outcome of the events described in these forward-looking statements is subject to known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. These risks and other factors include but are not limited to the successful completion of the Geneva Group acquisition and our ability to integrate the Geneva Group into our existing operations, continue the Geneva Group's seller relationships and buyer network and realize expected benefits of the acquisition, as well as the factors set forth in our Annual Report on Form 10-K for the year ended September 30, 2007. You can identify forward-looking statements by terminology such as may, will, should, could, would, expects, intends, plans, anticipates, believes, estimates, predicts, potential, continues or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. There may be other factors of which we are currently unaware or deem immaterial that may cause our actual results to differ materially from the forward-looking statements.

All forward-looking statements attributable to us or persons acting on our behalf apply only as of the date of this document and are expressly qualified in their entirety by the cautionary statements included in this document. Except as may be required by law, we undertake no obligation to publicly update or revise any forward-looking statement to reflect events or circumstances occurring after the date of this document or to reflect the occurrence of unanticipated events.

The following discussion should be read in conjunction with our consolidated financial statements and related notes and the information contained elsewhere in this document.

Overview

About us. We are a leading online auction marketplace for wholesale, surplus and salvage assets. We enable buyers and sellers to transact in an efficient, automated online auction environment offering over 500 product categories. Our marketplaces provide professional buyers access to a global, organized supply of wholesale, surplus and salvage assets presented with digital images and other relevant product information. Additionally, we enable our corporate and government sellers to enhance their financial return on excess assets by providing a liquid marketplace and value-added services that integrate sales and marketing, logistics and transaction settlement into a single offering. We organize our products into categories across major industry verticals such as consumer electronics, general merchandise, apparel, scientific equipment, aerospace parts and equipment, technology hardware, and specialty equipment. Our online auction marketplaces are www.liquidation.com, www.govliquidation.com, www.govdeals.com and www.liquibiz.com. We also operate a wholesale industry portal, www.goWholesale.com, that connects advertisers with buyers seeking products for resale and related business services.

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We believe our ability to create liquid marketplaces for wholesale, surplus and salvage assets generates a continuous flow of goods from our corporate and government sellers. This flow of goods in turn attracts an increasing number of professional buyers to our marketplaces. During the last 12 months, the number of registered buyers grew from approximately 613,000 to approximately 892,000, or 45.6%, including GovDeals.

Recent initiatives. On January 1, 2008, we completed the acquisition of the stock of Information Management Specialists, Inc. and its GovDeals, Inc. subsidiary for approximately \$9,389,000 in cash net of acquired cash of \$742,000. GovDeals is an online auction marketplace for the sale of surplus and confiscated items for local and state government entities including city, county and state agencies as well as school boards and public utilities. The acquisition strengthens our business by adding approximately 1,400 new government agency clients, approximately 80,000 new registered buyers and a critical mass of relationships to support new public sector business initiatives. In addition to a specialized sales force focused on building long term relationships with state and local agencies, GovDeals' business model allows sellers to list their own goods for sale on a consignment fee basis. The acquisition will also allow GovDeals' sellers to utilize our menu of optional value added services to save costs, improve cycle times and increase revenues.

On May 1, 2008, we acquired the companies in the Geneva Group, including Geneva Industries Ltd., Willen Trading Ltd., and Geneva Auctions Ltd., for approximately \$17.2 million in cash and contingent earn-out payments of up to an aggregate of approximately \$2.9 million payable over the next three years. The Geneva Group is a United Kingdom (UK) based remarketer of reverse supply chain merchandise, including customer returns and overstock merchandise. Geneva serves leading UK retailers and manufactures with a product focus on consumer electronics, technology equipment and hard goods general merchandise. We expect that the acquisition will strengthen our business by adding Geneva's longstanding seller relationships in the European Union (EU) with significant organic growth opportunities, as well as a complementary buyer network of UK based wholesalers and EU exporters developed over the last 18 years. We believe Geneva's buyer base will augment our marketplace by adding international demand for consumer electronics and general merchandise across all condition categories.

Our revenue. We generate substantially all of our revenue by retaining a percentage of the proceeds from the sales we manage for our sellers. We offer our sellers three primary transaction models: a profit-sharing model, a consignment model and a purchase model.

Profit-sharing model. Under our profit-sharing model, we purchase inventory from our suppliers and share with them a portion of the profits received from a completed sale in the form of a distribution. Distributions are calculated based on the value received from the sale after deducting direct costs, such as sales and marketing, technology and operations and other general and administrative costs. Because we are the primary obligor, and take general and physical inventory risks and credit risk under this transaction model, we recognize as revenue the sale price paid by the buyer upon completion of a transaction. Revenue from our profit-sharing model accounted for approximately 62.6% and 62.7% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The merchandise sold under our profit-sharing model accounted for approximately 44.6% and 49.2% of our gross merchandise volume, or GMV, for the three- and six-months ended March 31, 2008, respectively.

Consignment model. Under our consignment model, we recognize commission revenue from sales of merchandise in our marketplaces that is owned by others. These commissions, which we refer to as seller commissions, represent a percentage of the sale price the buyer pays upon completion of a transaction. We vary the percentage amount of the seller commission depending on the various value-added services we provide to the seller to facilitate the transaction. For example, we generally increase the percentage amount of the commission if we take possession, handle, ship or provide enhanced product information for the merchandise. We collect the seller commission by deducting the appropriate amount from the sales proceeds prior to their distribution to the seller after completion of the transaction. Revenue from our consignment model accounted for approximately 8.2% and 7.0% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The merchandise sold under our consignment model accounted for approximately 35.6% and 28.3% of our GMV for the three- and six-months ended March 31, 2008, respectively.

Purchase model. Under our purchase model, we offer our sellers a fixed amount or the option to share a portion of the proceeds received from our completed sales in the form of a distribution. Distributions are calculated based on the value we receive from the sale after deducting a required return to us that we have negotiated with the seller. Because we are the primary obligor, and take general and physical inventory risks and credit risk under this transaction model, we recognize as revenue the sale price paid by the buyer upon completion of a transaction. Revenue from our purchase model accounted for approximately 25.7% and 26.2% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The merchandise sold under our purchase model accounted for approximately 18.3% and 20.5% of our GMV for the three- and six-months ended March 31, 2008, respectively.

We collect a buyer premium on substantially all of our transactions under all of our transaction models. Buyer premiums are calculated as a percentage of the sale price of the merchandise sold and are paid to us by the buyer. Buyer premiums are in addition to the price of the merchandise. Under our profit-sharing model, we typically share the proceeds of any buyer premiums with our sellers.

In the three months ended March 31, 2008, we generated less than 2% of our revenue from advertisements on our wholesale industry portals.

Industry trends. We believe there are several industry trends impacting the growth of our business including: (1) the increase in the adoption of the Internet by businesses to conduct e-commerce both in the United States and abroad; (2) product innovation in the retail supply chain that has increased the pace of product obsolescence and, therefore, the supply of surplus assets; (3) the increase in the volume of returned merchandise handled by both online and offline retailers; (4) the increase in government regulations necessitating verifiable recycling and remarketing of surplus assets; and (5) the increase in outsourcing by corporate and government organizations of disposition activities for surplus and end-of-life assets.

Our Seller Agreements

Our DoD agreements. We have three contracts with the DoD pursuant to which we acquire, manage and sell excess property:

Surplus contract. In June 2001, we were awarded the CV2 contract, a competitive-bid exclusive contract under which we acquire, manage and sell all usable DoD surplus personal property turned into the Defense Reutilization and Marketing Service (DRMS). Surplus property generally consists of items determined by the DoD to be no longer needed, and not claimed for reuse by, any federal agency, such as computers, electronics, office supplies, scientific and medical equipment, aircraft parts, clothing and textiles. Revenue from our Surplus Contract (including buyer premiums) accounted for approximately 33.5% and 31.6% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The property sold under our Surplus Contract accounted for approximately 23.9% and 24.8% of our GMV for the three- and six-months ended March 31, 2008, respectively. The Surplus Contract expires in June 2008. We are in the process of responding to a RFP from the DRMS regarding a renewal of the Surplus Contract.

Scrap contract. In June 2005, we were awarded a competitive-bid exclusive contract under which we acquire, manage and sell substantially all scrap property of the DoD turned into the DRMS. Scrap property generally consists of items determined by DoD to have no use beyond their base material content, such as metals, alloys, and building materials. Revenue from our Scrap Contract (including buyer premiums) accounted for approximately 29.1% and 31.1% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The property sold under our Scrap Contract accounted for approximately 20.7% and 24.4% of our GMV for the three- and six-months ended March 31, 2008, respectively. We were required to pay \$5.7 million to the DoD in fiscal 2005 for the right to manage the operations and remarket scrap material in connection with the Scrap Contract. The Scrap Contract expires in June 2012, subject to DoD's right to extend it for three additional one-year terms.

Under the Surplus Contract, we are obligated to purchase all DoD surplus property at set prices representing a percentage of the original acquisition cost, which varies depending on the type of surplus property being purchased. Under the Scrap Contract, we acquire scrap property at a per pound price. We were initially entitled to approximately 20% of the profits of sale (defined as gross proceeds of sale less allowable operating expenses) under the Contracts, and the DoD was entitled to approximately 80% of the profits. We refer to these disbursement payments to DoD as profit-sharing distributions. As a result of these arrangements, we recognize as revenue the gross proceeds from these sales. DoD also reimburses us for actual costs incurred for packing, loading and shipping property under the contracts that we are obligated to pick up from non-DoD locations. On September 12, 2006, we entered into a bilateral contract modification under which the DoD agreed to increase our profit-sharing percentage under the Surplus Contract in exchange for our agreement to implement additional inventory assurance processes and procedures with respect to the sale of demilitarized property. Under the terms of the contract modification, from August 1, 2006 until November 30, 2006, we were entitled to receive 27.5% of the profits under the Surplus Contract and the DoD was entitled to receive 72.5%. Since November 30, 2006, we have been entitled to receive between 25% and 30.5% of the profits, based on the results of an audit of the effectiveness of the inventory controls we implemented under the contract modification. On June 1, 2007, we agreed, as provided in the modification to the Surplus Contract that became effective as of September 12, 2006, to provide additional value-added services with respect to demilitarized property that is returned to the DoD for reutilization. In exchange for our agreement to provide these services, the DoD exercised its existing option to increase our share of net proceeds under the Surplus Contract by 1%.

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Under the Scrap Contract, we also have a small business performance incentive based on the number of scrap buyers that are small businesses that would allow us to receive up to an additional 2% of the profit sharing distribution. On May 21, 2007, we entered into a bilateral contract modification under which the DoD agreed to increase the profit-sharing distribution for the Scrap Contract from 20% to 23% effective June 1, 2007, in exchange for our agreement to implement additional inventory assurance processes and procedures with respect to the mutilation of demilitarized scrap property sold.

In January 2006, we were awarded a contract to purchase DoD surplus property located in Germany. This contract generated less than 1% of our revenue in the three months ended March 31, 2008. This contract expires in January 2009.

Our UK MoD agreement. In July 2003, we were awarded a contract to manage and sell surplus property from the United Kingdom Ministry of Defence. This contract generated less than 2% of our revenue in the three months ended March 31, 2008. This contract expires in July 2008, subject to the Ministry's right to extend the contract for two additional one-year terms.

Our commercial agreements. We have over 340 corporate clients each of which sells in excess of \$10,000 of wholesale, surplus and salvage assets in our marketplaces. Our agreements with these clients are generally terminable at will by either party.

Key Business Metrics

Our management periodically reviews certain key business metrics for operational planning purposes and to evaluate the effectiveness of our operational strategies, allocation of resources and our capacity to fund capital expenditures and expand our business. These key business metrics include:

Gross merchandise volume. Gross merchandise volume, or GMV, is the total sales value of all merchandise sold through our marketplaces during a given period. We review GMV because it provides a measure of the volume of goods being sold in our marketplaces and thus the activity of those marketplaces. GMV also provides a means to evaluate the effectiveness of investments that we have made and continue to make, including in the areas of customer support, value-added services, product development, sales and marketing, and operations. The GMV of goods sold in our marketplaces during the three- and six-months ended March 31, 2008 totaled \$88.2 million and \$155.8 million, respectively.

Completed transactions. Completed transactions represents the number of auctions in a given period from which we have recorded revenue. Similar to GMV, we believe that completed transactions is a key business metric because it provides an additional measurement of the volume of activity flowing through our marketplaces. During the three- and six-months ended March 31, 2008 we completed approximately 91,000 and 154,000 transactions, respectively, which includes three months of GovDeals.

Total registered buyers. We grow our buyer base through a combination of marketing and promotional efforts. A person becomes a registered buyer by completing an online registration process on one of our marketplaces. As part of this process, we collect business and personal information, including name, title, company name, business address and contact information, and information on how the person intends to use our marketplaces. Each prospective buyer must also accept our terms and conditions of use. Following the completion of the online registration process, we verify each prospective buyer's e-mail address and confirm that the person is not listed on any banned persons list maintained internally or by the U.S. federal government. After the verification process, which is completed generally within 24 hours, the registration is approved and activated and the prospective buyer is added to our registered buyer list.

Total registered buyers as of a given date represents the aggregate number of persons or entities who have registered on one of our marketplaces. We use this metric to evaluate how well our marketing and promotional efforts are performing. Total registered buyers excludes duplicate registrations, buyers who are suspended from utilizing our marketplaces and those buyers who have voluntarily removed themselves from our registration database. In addition, if we become aware of registered buyers that are no longer in business, we remove them from our database. As of March 31, 2008, we had approximately 892,000 registered buyers, including GovDeals.

Total auction participants. For each auction we manage, the number of auction participants represents the total number of registered buyers who have bid one or more times in that auction. As a result, a registered buyer who bids, or participates, in more than one auction is counted as an auction participant in each auction in which he or she participates. Thus, total auction participants for a given period is the sum of the auction participants in each auction

conducted during that period. We use this metric to allow us to compare our online auction marketplaces to our competitors, including other online auction sites and traditional on-site auctioneers. In addition, we measure total auction participants on a periodic basis to evaluate the activity level of our base of registered buyers and to measure the performance of our marketing and promotional efforts. For the three- and six-months ended March 31, 2008, approximately 463,000 and 786,000 total auction participants participated in auctions on our marketplaces, respectively, which includes three months of GovDeals.

Non-GAAP Financial Measures

EBITDA and adjusted EBITDA. EBITDA is a supplemental non-GAAP financial measure and is equal to net income plus (a) interest expense (income) and other expense (income), net; (b) provision for income taxes; (c) amortization of contract intangibles; and (d) depreciation and amortization. Our definition of adjusted EBITDA differs from EBITDA because we further adjust EBITDA for stock-based compensation expense.

We believe EBITDA and adjusted EBITDA are useful to an investor in evaluating our performance for the following reasons:

The amortization of contract intangibles relates to amortization of the Scrap Contract beginning in June 2005. Depreciation and amortization expense primarily relates to property and equipment. Both of these expenses are non-cash charges that have fluctuated significantly over the past five years. As a result, we believe that adding back these non-cash charges to net income is useful in evaluating the operating performance of our business on a consistent basis from year-to-year.

As a result of varying federal and state income tax rates, we believe that presenting a financial measure that adjusts net income for provision for income taxes is useful to investors when evaluating the operating performance of our business.

During July 2001, we modified the exercise price of 3,402,794 stock options issued to employees. As a result, we are accounting for the modified stock options from the date of modification to the date the stock options are exercised, forfeited or expire unexercised using variable accounting. Under variable accounting, we revalue compensation costs for the stock options at each reporting period based on changes in the intrinsic value of the stock options. We will continue to revalue compensation costs for the options based on changes in the fair value of our common stock in future periods. As a result, we present a financial measure that adjusts net income and EBITDA for the stock compensation expense that results from the July 2001 modification of these stock options. We believe that it is useful to exclude this expense because it results from a one-time event that requires us to record expense that we are not otherwise required to record in connection with new stock options granted during the same time period. In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, or Statement 123(R), which is a revision of SFAS No. 123. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. Pro forma disclosure is no longer an alternative. We adopted the provisions of Statement 123(R) on October 1, 2005, using the prospective method. Unvested stock based awards issued prior to October 1, 2005, the date that we adopted the provisions of Statement 123(R), will be accounted for at the date of adoption using the intrinsic value method originally applied to those awards. Accordingly, we believe adjusting net income for this non-cash stock based compensation expense is useful to investors when evaluating the operating performance of our business.

We believe these measures are important indicators of our operational strength and the performance of our business because they provide a link between profitability and operating cash flow.

We also believe that analysts and investors use EBITDA and adjusted EBITDA as supplemental measures to evaluate the overall operating performance of companies in our industry.

Our management uses EBITDA and adjusted EBITDA:

as measurements of operating performance because they assist us in comparing our operating performance on a consistent basis as they remove the impact of items not directly resulting from our core operations;

for planning purposes, including the preparation of our internal annual operating budget;

to allocate resources to enhance the financial performance of our business;

to evaluate the effectiveness of our operational strategies; and

to evaluate our capacity to fund capital expenditures and expand our business.

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EBITDA and adjusted EBITDA as calculated by us are not necessarily comparable to similarly titled measures used by other companies. In addition, EBITDA and adjusted EBITDA: (a) do not represent net income or cash flows from operating activities as defined by GAAP; (b) are not necessarily indicative of cash available to fund our cash flow needs; and (c) should not be considered as alternatives to net income, income from operations, cash provided by operating activities or our other financial information as determined under GAAP.

We prepare adjusted EBITDA by adjusting EBITDA to eliminate the impact of items that we do not consider indicative of our core operating performance. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. As an analytical tool, adjusted EBITDA is subject to all of the limitations applicable to EBITDA. Our presentation of adjusted EBITDA should not be construed as an implication that our future results will be unaffected by unusual or non-recurring items.

The table below reconciles net income to EBITDA and adjusted EBITDA for the periods presented.

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---------------------------------|-----------------|-------------------------------|-----------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (in thousands) (unaudited) | | | |
| Net income | \$ 2,646 | \$ 2,474 | \$ 5,009 | \$ 4,787 |
| Interest expense (income) and other expense (income), net | (621) | (551) | (1,109) | (1,149) |
| Provision for income taxes | 1,862 | 1,746 | 3,504 | 3,288 |
| Amortization of contract intangibles | 203 | 203 | 407 | 407 |
| Depreciation and amortization | 465 | 309 | 852 | 581 |
| EBITDA | 4,555 | 4,181 | 8,663 | 7,914 |
| Stock compensation expense | 1,151 | 519 | 2,263 | 883 |
| Adjusted EBITDA | \$ 5,706 | \$ 4,700 | \$ 10,926 | \$ 8,797 |

Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. A critical accounting estimate is one which is both important to the portrayal of our financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. We continuously evaluate our critical accounting estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue recognition. We recognize revenue in accordance with the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*. For transactions in our online marketplaces, which generate substantially all of our revenue, we recognize revenue when all of the following criteria are met:

a buyer submits the winning bid in an auction and, as a result, evidence of an arrangement exists and the sale price has been determined;

title has passed to a buyer and the buyer has assumed risks and rewards of ownership;

for arrangements with an inspection period, the buyer has received the merchandise and has not notified us within that period that it is dissatisfied with the merchandise; and

collection is reasonably assured.

Substantially all of our sales are recorded subsequent to payment authorization being received, utilizing credit cards, wire transfers and PayPal, an Internet based payment system, as methods of payments. As a result, we are not subject to significant collection risk, as goods are generally not shipped before payment is received.

Revenue is also evaluated in accordance with EITF 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, for reporting revenue of gross proceeds as the principal in the arrangement or net of commissions as an agent. In arrangements in which we are deemed to be the primary obligor, bear physical and general inventory risk, and credit risk, we recognize as revenue the gross proceeds from the sale, including buyer's premiums. Arrangements in which we act as an agent or broker on a consignment basis, without taking general or physical inventory risk, revenue is recognized based on the sales commissions that are paid to us by the sellers for utilizing our services; in this situation, sales commissions represent a percentage of the gross proceeds from the sale that the seller pays to us upon completion of the transaction.

We have evaluated our revenue recognition policy related to sales under our profit-sharing model and determined it is appropriate to account for these sales on a gross basis using the criteria outlined in EITF 99-19. The following factors were most heavily relied upon in our determination:

We are the primary obligor in the arrangement.

We are the seller in substance and in appearance to the buyer; the buyer contacts us if there is a problem with the purchase. Only we and the buyer are parties to the sales contract and the buyer has no recourse to the supplier. If the buyer has a problem, he or she looks to us, not the supplier.

The buyer does not and cannot look to the supplier for fulfillment or for product acceptability concerns.

We have general inventory risk.

We take title to the inventory upon paying the amount set forth in the contract with the supplier. Such amount is generally a percentage of the supplier's original acquisition cost and varies depending on the type of the inventory purchased.

We are at risk of loss for all amounts paid to the supplier in the event the property is damaged or otherwise becomes unsaleable. In addition, as payments made for inventory are excluded from the calculation for the profit-sharing distribution under our DoD contracts, we effectively bear inventory risk for the full amount paid to acquire the property (*i.e.*, there is no sharing of inventory risk).

Valuation of goodwill and other intangible assets. In accordance with SFAS No. 141, *Business Combinations*, we identify and value intangible assets that we acquire in business combinations, such as customer arrangements, customer relationships and non-compete agreements, that arise from contractual or other legal rights or that are capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged. The fair value of identified intangible assets is based upon an estimate of the future economic benefits expected to result from ownership, which represents the amount at which the assets could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we test our goodwill and other intangible assets for impairment annually or more frequently if events or circumstances indicate impairment may exist. Examples of such events or circumstances could include a significant change in business climate or a loss of significant customers. We apply a two-step fair value-based test to assess goodwill for impairment. The first step compares the fair value of a reporting unit to its carrying amount, including goodwill. If the carrying amount of the reporting unit exceeds its fair value, the second step is then performed. The second step compares the carrying amount of the reporting unit's goodwill to the fair value of the goodwill. If the fair value of the goodwill is less than the carrying amount, an impairment loss would be recorded in our statements of operations. Intangible assets with definite lives are amortized over their estimated useful lives and are also reviewed for impairment if events or changes in circumstances indicate that their carrying amount may not be realizable.

Our management makes certain estimates and assumptions in order to determine the fair value of net assets and liabilities, including, among other things, an assessment of market conditions, projected cash flows, cost of capital and growth rates, which could significantly impact the reported value of goodwill and other intangible assets. Estimating future cash flows requires significant judgment, and our projections may vary from cash flows eventually realized. The valuations employ a combination of present value techniques to measure fair value, corroborated by comparisons to estimated market multiples. These valuations are based on a discount rate determined by our management to be consistent with industry discount rates and the risks inherent in our current business model.

We cannot predict the occurrence of certain future events that might adversely affect the reported value of goodwill and other intangible assets, which totaled \$24.9 million at March 31, 2008. Such events may include strategic decisions made in response to economic and competitive conditions, the impact of the economic environment on our base of buyers and sellers or material negative changes in our relationships with material customers.

Income taxes. We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. This statement requires an asset and liability approach for measuring deferred taxes based on temporary differences between the financial statement and income tax bases of assets and liabilities existing at each balance sheet date using enacted tax rates for the years in which the taxes are expected to be paid or recovered. A valuation allowance is provided to reduce the deferred tax assets to a level that we believe will more likely than not be realized. The resulting net deferred tax asset reflects management's estimate of the amount that will be realized.

We provide for income taxes based on our estimate of federal and state tax liabilities. These estimates include, among other items, effective rates for state and local income taxes, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Our estimates are based on the information available to us at the time we prepare the income tax provision. We generally file our annual income tax returns several months after our fiscal year-end. Income tax returns are subject to audit by federal, state and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

Stock-based compensation. We account for stock-based compensation in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which is a revision of SFAS No. 123. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. The Company uses the Black-Scholes option pricing model to estimate the fair values of share-based payments.

The above list is not intended to be a comprehensive list of all of our accounting estimates. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP, with little need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited financial statements and related notes, which contain accounting policies and other disclosures required by GAAP.

Components of Revenue and Expenses

Revenue. We generate substantially all of our revenue from sales of merchandise held in inventory and by retaining a percentage of the proceeds from the sales. Our revenue recognition practices are discussed in more detail in the section above entitled *Critical Accounting Estimates*.

Cost of goods sold (excluding amortization). Cost of goods sold includes the costs of purchasing and transporting property for auction, as well as credit card transaction fees.

Profit-sharing distributions. Our two primary contracts with the DoD are structured as profit-sharing arrangements in which we purchase and take possession of all goods we receive from the DoD at a contractual percentage of the original acquisition cost of those goods. After deducting allowable operating expenses, we disburse to the DoD on a monthly basis a percentage of the profits of the aggregate monthly sales. We retain the remaining percentage of these profits after the DoD's disbursement. We refer to these disbursement payments to DoD as profit-sharing distributions.

Technology and operations. Technology expenses consist primarily of personnel costs related to our programming staff who develop and deploy new marketplaces, such as *liquibiz.com*, and continuously enhance existing marketplaces. These personnel also develop and upgrade the software systems that support our operations, such as sales processing. Because our marketplaces and support systems require frequent upgrades and enhancements to maintain viability, we have determined that the useful life for substantially all of our internally developed software is less than one year. As a result, we expense these costs as incurred.

Operations expenses consist primarily of operating costs, including buyer relations, shipping logistics and distribution center operating costs.

Sales and marketing. Sales and marketing expenses include the cost of our sales and marketing personnel as well as the cost of marketing and promotional activities. These activities include online marketing campaigns such as paid search advertising.

General and administrative. General and administrative expenses include all corporate and administrative functions that support our operations and provide an infrastructure to facilitate our future growth. Components of these expenses include executive management and staff salaries, bonuses and related taxes and employee benefits; travel; headquarters rent and related occupancy costs; and legal and accounting fees. The salaries, bonus and employee benefits costs included as general and administrative expenses are generally more fixed in nature than our operating expenses and do not vary directly with the volume of merchandise sold through our marketplaces.

Amortization of contract intangibles. Amortization of contract intangibles expense consists of the amortization of our DoD Scrap Contract award during June 2005. This contract required us to purchase the rights to operate the scrap operations of the DoD during the seven year base term of the contract. The intangible asset created from the \$5.7 million purchase is being amortized over 84 months on a straight-line basis. The amortization period is correlated to the base term of the contract, exclusive of renewal periods.

Depreciation and amortization. Depreciation and amortization expenses consist primarily of the depreciation and amortization of amounts recorded in connection with the purchase of furniture, fixtures and equipment.

Interest income and expense and other income, net. Interest income and expense and other income, net consists primarily of interest income on cash and short-term investments and interest expense on borrowings under our notes payable and realized gains or losses on short-term investments.

Income taxes. During fiscal years 2006 and 2007, we had an effective income tax rate of approximately 40%, which included federal and state income taxes. We estimate that our future effective income tax rate will be approximately 41%.

Results of Operations

The following table sets forth, for the periods indicated, selected statement of operations data expressed as a percentage of revenue.

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---------------------------------|--------|-------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Costs and expenses: | | | | |
| Cost of goods sold (excluding amortization) | 25.7 | 23.4 | 25.8 | 21.1 |
| Profit-sharing distributions | 36.0 | 36.3 | 35.5 | 38.8 |
| Technology and operations | 16.4 | 17.1 | 16.6 | 17.2 |
| Sales and marketing | 6.2 | 6.6 | 6.7 | 6.6 |
| General and administrative | 8.4 | 8.2 | 8.3 | 7.9 |
| Amortization of contract intangibles | 0.4 | 0.4 | 0.4 | 0.4 |
| Depreciation and amortization | 0.7 | 0.6 | 0.6 | 0.6 |
| Total costs and expenses | 93.8 | 92.6 | 93.9 | 92.6 |
| Income from operations | 6.2 | 7.4 | 6.1 | 7.4 |
| Interest income (expense) and other income, net | 1.0 | 1.1 | .9 | 1.2 |
| Income before provision for income taxes | 7.2 | 8.5 | 7.0 | 8.6 |
| Provision for income taxes | (3.0) | (3.5) | (2.9) | (3.5) |
| Net income | 4.2% | 5.0% | 4.1% | 5.1% |

Three Months Ended March 31, 2008 Compared to Three Months Ended March 31, 2007

Revenue. Revenue increased \$13.5 million, or 27.5%, to \$62.8 million for the three months ended March 31, 2008 from \$49.3 million for the three months ended March 31, 2007, primarily due to an increase in the number of completed transactions, which increased from approximately 52,000 to 91,000, or 73.6%. The amount of gross merchandise volume increased \$28.2 million, or 47.1%, to \$88.2 million for the three months ended March 31, 2008 from \$60.0 million for the three months ended March 31, 2007, primarily due to (1) our scrap business, which generated 29.1% of our revenue and 20.7% of our gross merchandise volume for the three months ended March 31, 2008, grew 33.2%; (2) our surplus business, which generated 33.5% of our revenue and 23.9% of our gross merchandise volume for the three months ended March 31, 2008, grew 37.8%; and (3) the acquisition of GovDeals completed on January 1, 2008, which generated 1.8% of our revenue and 18.0% of our gross merchandise volume for the three months ended March 31, 2008. We also benefited from our ability to more effectively market assets to potential buyers; our marketing efforts resulted in an approximate 45.6% increase in registered buyers to approximately 892,000 at March 31, 2008 from approximately 613,000 at March 31, 2007, including GovDeals.

Cost of goods sold (excluding amortization). Cost of goods sold (excluding amortization) increased \$4.7 million, or 40.1%, to \$16.2 million for the three months ended March 31, 2008 from \$11.5 million for the three months ended March 31, 2007. As a percentage of revenue, cost of goods sold (excluding amortization) increased to 25.7% from 23.4%. These

increases are primarily due to (1) an increase in the volume of goods sold by existing sellers utilizing our purchase model; (2) a ramp up in volume with existing sales programs which resulted in lower inventory turnover; and (3) a mix shift to apparel items, which realized a lower margin during the three months ended March 31, 2008.

Profit-sharing distributions. Profit-sharing distributions increased \$4.7 million, or 26.5%, to \$22.6 million for the three months ended March 31, 2008 from \$17.9 million for the three months ended March 31, 2007, primarily due to 37.8% growth in our surplus business and 33.2% growth in our scrap business. As a percentage of revenue, profit-sharing distributions decreased to 36.0% from 36.3%, primarily due to a decrease in the amount of profits we are required to pay the DoD under our Surplus Contract, which was modified on September 12, 2006, as well as the Scrap Contract, which was modified on June 1, 2007. A detailed discussion of the Surplus and Scrap Contract modifications can be found above under Our Seller Agreements.

Technology and operations expenses. Technology and operations expenses increased \$1.9 million, or 22.7%, to \$10.3 million for the three months ended March 31, 2008 from \$8.4 million for the three months ended March 31, 2007, primarily due to (1) the addition of 71 technology and operations personnel, the majority of whom were needed to support the increased volume of transactions and merchandise discussed above; (2) an additional 30 operating personnel, who were needed to support our inventory assurance program under the Surplus Contract; and (3) the acquisition of GovDeals, which was completed on January 1, 2008. As a percentage of revenue, these expenses decreased to 16.4% from 17.1%, primarily due to our growth in revenue, while leveraging our fixed expenses, such as programming personnel.

Sales and marketing expenses. Sales and marketing expenses increased \$0.7 million, or 21.5%, to \$3.9 million for the three months ended March 31, 2008 from \$3.2 million for the three months ended March 31, 2007, primarily due to (1) our hiring of 14 additional sales and marketing personnel; (2) \$0.4 million in increased expenditures on marketing and promotional activities across our marketplaces; and (3) the acquisition of GovDeals, which was completed on January 1, 2008. As a percentage of revenue, these expenses decreased to 6.2% from 6.6%, primarily due to our growth in revenue, while leveraging our fixed expenses, such as marketing personnel.

General and administrative expenses. General and administrative expenses increased \$1.3 million, or 30.2%, to \$5.3 million for the three months ended March 31, 2008 from \$4.0 million for the three months ended March 31, 2007. As a percentage of revenue, these expenses increased to 8.4% from 8.2%. These increases are primarily due to (1) costs of \$0.2 million related to additional accounting, legal, insurance, compliance and other expenses needed to support our growth; (2) expenses of \$0.3 million related to the adoption of Statement 123(R); (3) costs of \$0.1 million for travel related expenses associated with business development efforts; and (4) expenses of \$0.2 million associated with GovDeals, which was acquired on January 1, 2008.

Amortization of contract intangibles. Amortization of contract intangibles was \$0.2 million for the three months ended March 31, 2008 and 2007, as a result of our DoD Scrap Contract award during June 2005. This contract required us to purchase the rights to operate the scrap operations of the DoD during the seven-year base term of the contract. The intangible asset created from the \$5.7 million purchase is being amortized on a straight-line basis over 84 months, which began in August 2005.

Depreciation and amortization expenses. Depreciation and amortization expenses increased \$0.2 million, or 50.5%, to \$0.5 million for the three months ended March 31, 2008 from \$0.3 million for the three months ended March 31, 2007, primarily due to additional depreciation expense resulting from the purchase of \$2.7 million of property and equipment during the fiscal year ended September 30, 2007.

Interest income and expense and other income, net. Interest income and expense and other income, net was consistent at \$0.6 million for the three months ended March 31, 2008 and 2007.

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Provision for income tax expense. Income tax expense increased \$0.2 million, or 6.7%, to \$1.9 million for the three months ended March 31, 2008 from \$1.7 million for the three months ended March 31, 2007, primarily due to the increase in income before provision for income taxes.

Net income. Net income increased \$0.1 million, or 7.0%, to \$2.6 million for the three months ended March 31, 2008 from \$2.5 million for the three months ended March 31, 2007.

Six Months Ended March 31, 2008 Compared to Six Months Ended March 31, 2007

Revenue. Revenue increased \$27.7 million, or 29.3%, to \$122.1 million for the six months ended March 31, 2008 from \$94.4 million for the six months ended March 31, 2007, primarily due to an increase in the number of completed transactions from approximately 101,000 to 154,000, or 51.9%. The amount of gross merchandise volume increased \$42.6 million, or 37.7%, to \$155.8 million for the six months ended March 31, 2008 from \$113.2 million for the six months ended March 31, 2007, primarily due to (1) our scrap business, which generated 31.1% of our revenue and 24.4% of our gross merchandise volume for the six months ended March 31, 2008, grew 44.8%; and (2) the acquisition of GovDeals completed on January 1, 2008, which generated 0.9% of our revenue and 10.2% of our gross merchandise volume for the six months ended March 31, 2008. During the last 12 months, we also benefited from our ability to more effectively market assets to potential buyers as we gained transaction experience and industry knowledge in the vertical product segments auctioned through our marketplaces.

Cost of goods sold (excluding amortization). Cost of goods sold (excluding amortization) increased \$11.6 million, or 57.8%, to \$31.6 million for the six months ended March 31, 2008 from \$20.0 million for the six months ended March 31, 2007. As a percentage of revenue, cost of goods sold (excluding amortization) increased to 25.8% from 21.1%. These increases are primarily due to (1) an increase in the volume of goods sold by existing sellers utilizing our purchase model; (2) a ramp up in volume with existing sales programs which resulted in lower inventory turnover; and (3) a mix shift to apparel items, which realized a lower margin during the six months ended March 31, 2008.

Profit-sharing distributions. Profit-sharing distributions increased \$6.8 million, or 18.6%, to \$43.4 million for the six months ended March 31, 2008 from \$36.6 million for the six months ended March 31, 2007, primarily due to 14.4% growth in our surplus business and 44.8% growth in our scrap business. As a percentage of revenue, profit-sharing distributions decreased to 35.5% from 38.8%, primarily due to a decrease in the amount of profits we are required to pay the DoD under our Surplus Contract, which was modified on September 12, 2006, as well as the Scrap Contract, which was modified on June 1, 2007. A detailed discussion of the Surplus and Scrap Contract modifications can be found above under Our Seller Agreements.

Technology and operations expenses. Technology and operations expenses increased \$4.1 million, or 24.9%, to \$20.3 million for the six months ended March 31, 2008 from \$16.2 million for the six months ended March 31, 2007, primarily due to (1) the addition of 106 technology and operations personnel, the majority of whom were needed to support the increased volume of transactions and merchandise discussed above; (2) an additional 63 operating personnel, who were needed to support our inventory assurance program under the Surplus Contract; and (3) the acquisition of GovDeals, which was completed on January 1, 2008. As a percentage of revenue, these expenses decreased to 16.6% from 17.2%, primarily due to our growth in revenue, while leveraging our fixed expenses, such as programming personnel.

Sales and marketing expenses. Sales and marketing expenses increased \$1.9 million, or 30.1%, to \$8.1 million for the six months ended March 31, 2008 from \$6.2 million for the six months ended March 31, 2007, primarily due to (1) our hiring of 32 additional sales and marketing personnel; (2) \$0.6 million in increased expenditures on marketing and promotional activities across our marketplaces; and (3) the acquisition of GovDeals, which was completed on January 1, 2008. As a percentage of revenue, these expenses were 6.7% for the six months ended March 31, 2008 and 6.6% for the six months ended March 31, 2007.

General and administrative expenses. General and administrative expenses increased \$2.6 million, or 35.1%, to \$10.1 million for the six months ended March 31, 2008 from \$7.5 million for the six months ended March 31, 2007. As a percentage of revenue, these expenses increased to 8.3% from 7.9%. These increases are primarily due to (1) costs of \$1.0 million related to additional accounting, legal, insurance, compliance and other expenses needed to support our growth; (2) expenses of \$0.4 million related to the adoption of Statement 123(R); (3) costs of \$0.3 million for travel related expenses associated with business development efforts; and (4) expenses of \$0.2 million associated with GovDeals, which was acquired on January 1, 2008.

Amortization of contract intangibles. Amortization of contract intangibles was \$0.4 million for the six months ended March 31, 2008 and 2007, as a result of our DoD Scrap Contract award during June 2005. This contract required us to purchase the rights to operate the scrap operations of the DoD during the seven-year base term of the contract. The intangible asset created from the \$5.7 million purchase is being amortized on a straight-line basis over 84 months, which began in August 2005.

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Depreciation and amortization expenses. Depreciation and amortization expenses increased \$0.3 million, or 46.6%, to \$0.9 million for the six months ended March 31, 2008 from \$0.6 million for the six months ended March 31, 2007, primarily due to additional depreciation expense resulting from the purchase of \$2.7 million of property and equipment during the fiscal year ended September 30, 2007.

Interest income and expense and other income, net. Interest income and expense and other income, net was \$1.1 million for the six months ended March 31, 2008 and 2007.

Provision for income tax expense. Income tax expense increased \$0.2 million, or 6.6%, to \$3.5 million for the six months ended March 31, 2008 from \$3.3 million for the six months ended March 31, 2007, primarily due to the increase in income before provision for income taxes.

Net income. Net income increased \$0.2 million, or 4.7%, to \$5.0 million for the six months ended March 31, 2008 from \$4.8 million for the six months ended March 31, 2007.

Liquidity and Capital Resources

Historically, our primary cash needs have been working capital (including capital used for inventory purchases), which we have funded primarily through cash generated from operations. As of March 31, 2008, we had approximately \$40.4 million in cash and cash equivalents, \$22.0 million in short-term investments and \$25.9 million available under our \$30.0 million senior credit facility, due to issued letters of credit for \$4.1 million.

Substantially all of our sales are recorded subsequent to receipt of payment authorization, utilizing credit cards, wire transfers and PayPal, an Internet based payment system, as methods of payments. As a result, we are not subject to significant collection risk, as goods are generally not shipped before payment is received.

Changes in Cash Flows: Six Months Ended March 31, 2008 Compared to Six Months Ended March 31, 2007

Net cash provided by operating activities increased \$8.2 million to \$11.1 million for the six months ended March 31, 2008 from \$2.9 million for the six months ended March 31, 2007. For the six months ended March 31, 2008, net cash provided by operating activities primarily consisted of net income of \$5.0 million, depreciation and amortization expense of \$1.3 million, stock compensation expense of \$2.3 million, and a net increase in accounts payable, accrued expenses and other liabilities of \$2.8 million, offset in part by a net increase in accounts receivable, inventory and prepaid assets of \$0.1 million and a decrease in the provision for doubtful accounts of \$0.2 million. For the six months ended March 31, 2007, net cash provided by operating activities primarily consisted of net income of \$4.8 million, depreciation and amortization expense of \$1.0 million, net other expenses of \$0.9 million and a net increase in accounts payable, accrued expenses and other liabilities of \$5.8 million, offset in part by an increase in accounts receivable, inventory and prepaid expenses and other assets of \$9.6 million.

Net cash used in investing activities was \$10.6 million for the six months ended March 31, 2008 and \$9.8 million for the six months ended March 31, 2007. Net cash used in investing activities for the six months ended March 31, 2008 consisted primarily of net purchases of short-term investments of \$0.5 million, \$9.4 million for the purchase of GovDeals and capital expenditures of \$0.7 million for purchases of equipment and leasehold improvements. Net cash used in investing activities for the six months ended March 31, 2007 consisted primarily of capital expenditures of \$1.7 million for purchases of equipment and leasehold improvements, and \$10.2 million for the purchase of STR, offset in part by net proceeds from the sale of short-term investments of \$2.1 million.

Net cash provided by financing activities was \$0.1 million for the six months ended March 31, 2008 and \$2.4 million for the six months ended March 31, 2007. Net cash provided by financing activities for the six months ended March 31, 2007 consisted primarily of net proceeds from our follow on public stock offering of \$1.3 million and proceeds from the exercise of common stock options including the tax benefit of \$1.2 million, offset in part by the repayment of notes payable and lease obligations of \$0.1 million.

Capital Expenditures. Our capital expenditures consist primarily of computers and purchased software, office equipment, furniture and fixtures, and leasehold improvements. The timing and volume of such capital expenditures in the future will be affected by the addition of new customers or expansion of existing customer relationships. We expect capital expenditures to range from \$2.0 million to \$2.5 million in the fiscal year ending September 30, 2008. We intend to fund those expenditures primarily from operating cash flows. Our capital expenditures for the three- and six-months ended March 31, 2008 were \$0.4 million and \$0.8 million, respectively. As of March 31, 2008, we had no outstanding commitments for capital expenditures.

Senior credit facility. We maintain a \$30.0 million senior credit facility due March 31, 2010. The senior credit facility bears an annual interest rate of LIBOR plus 1.5%. As of March 31, 2008, we had no outstanding indebtedness under our senior credit facility and our borrowing availability was \$25.9 million due to issued Letters of Credit for \$4.1 million; \$1.0 million of our availability under this facility is set aside as a contractual obligation under our DoD Scrap Contract. The obligations under our senior credit facility are unconditionally guaranteed by us and each of our existing and subsequently acquired or organized subsidiaries (other than our subsidiaries organized to service our DoD contracts) and secured on a first priority basis by security interests (subject to permitted liens) in substantially all assets owned by us, and each of our other domestic subsidiaries, subject to limited exceptions. Our credit agreement contains a number of affirmative and restrictive covenants including limitations on mergers, consolidations and dissolutions, sales of assets, investments and acquisitions, indebtedness and liens, and dividends and other restricted payments. As of March 31, 2008, we were in full compliance with the terms and conditions of our credit agreement.

We believe that our existing cash and cash equivalents and short term investments, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our rate of revenue growth, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the development and deployment of new marketplaces, the introduction of new value added services and the costs to establish additional distribution centers. We may enter into definitive agreements with respect to potential investments in, or acquisitions of, complementary businesses, products or technologies in the future, which could also require us to seek additional equity or debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased interest expense and could result in covenants that would restrict our operations. There is no assurance that such financing, if required, will be available in amounts or on terms acceptable to us, if at all.

Off-Balance Sheet Arrangements

We do not have any transactions, obligations or relationships that could be considered material off-balance sheet arrangements.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a framework for measuring fair value under generally accepted accounting principles, clarifies the definition of fair value and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect SFAS No. 157 to have a material effect on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 permits entities to choose to measure certain financial instruments and other items at fair value. The fair value option generally may be applied instrument by instrument, is irrevocable, and is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We do not expect SFAS No. 159 to have a material effect on our financial statements.

In June 2006, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 06-3, How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation) (EITF 06-3) by concluding that companies should disclose their accounting policy (i.e., gross or net presentation) regarding presentation of taxes within the scope of this issue. The Task Force also concluded that, as of January 1, 2007, companies should disclose the amount of such taxes for periods in which these taxes included in gross revenues are considered material. We collect and remit sales taxes on merchandise that we purchase and sell, and report such amounts under the net method in our consolidated statements of operations.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations. This statement changes the accounting for acquisitions specifically eliminating the step acquisition model, changing the recognition of contingent consideration from being recognized when it is probable to being recognized at the time of acquisition, disallowing the capitalization of transaction costs and delays when restructurings related to acquisitions can be recognized. The Company will adopt this statement for its fiscal year beginning October 1, 2009 and it will only impact the accounting for acquisitions we make after its adoption.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Interest rate sensitivity. We did not have any debt as of March 31, 2008 and September 30, 2007 and thus do not have any related interest rate exposure. Our investment policy requires us to invest funds in excess of current operating requirements. The principal objectives of our investment activities are to preserve principal, provide liquidity and maximize income consistent with minimizing risk of material loss.

As of March 31, 2008, our cash and cash equivalents consisted primarily of money market funds and our short term investments consisted primarily of highly rated short term bonds. The recorded carrying amounts of cash and cash equivalents approximate fair value due to their short maturities. Our interest income is sensitive to changes in the general level of interest rates in the United States, particularly since the majority of our investments are short-term in nature. Due to the nature of our short-term investments, which have a duration of three to twelve months, we have concluded that we do not have material market risk exposure.

Exchange rate sensitivity. We consider our exposure to foreign currency exchange rate fluctuations to be minimal, as less than three percent of our sales are denominated in foreign currencies. We have not engaged in any hedging or other derivative transactions to date.

Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

During the most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

As of March 31, 2008, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we may become involved in litigation relating to claims arising in the ordinary course of our business. There are no claims or actions pending or threatened against us that, if adversely determined, would in our judgment have a material adverse effect on us.

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factor set forth below and the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended September 30, 2007, which could materially affect our business, financial condition or future results. The risks described in this Quarterly Report and our Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

If we are awarded a new surplus contract with less favorable terms than those of the current Surplus Contract, we could experience a significant decrease in our revenue and income.

We depend on our surplus contract with the U.S. Department of Defense for a significant portion of our revenue. If we are not awarded a new Surplus Contract with the DRMS, or if we are awarded a new contract under terms less favorable than those in our current Surplus Contract, we could experience a significant decrease in our revenue and income. Revenue from our Surplus Contract (including buyer premiums) accounted for approximately 33.5% and 31.6% of our total revenue for the three- and six-months ended March 31, 2008, respectively. The property sold under our Surplus Contract accounted for approximately 23.9% and 24.8% of our GMV for the three- and six-months ended March 31, 2008, respectively. The Surplus Contract expires in June 2008 and we are currently participating in a competitive bidding process for the award of a new surplus contract. If we are awarded a new surplus contract, we expect that the new surplus contract will contain certain terms that are different from the terms of the current surplus contract, including, without limitation: (1) a change in the economic structure of the contract, which eliminates the profit sharing terms of the contract, (2) a 36 month term (with two 12 month renewal options) and (3) a mutual termination of the contract for convenience. The proposed terms of the new surplus contract can be found at www.drms.dla.mil/sales/UPSIFBMasterR2.pdf. We can not predict what effect these terms would have on our business if we were awarded a new surplus contract. In addition, we cannot assure you that such terms would not have a material adverse affect on our revenue and earnings.

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

The 2008 Annual Meeting of Stockholders of Liquidity Services, Inc. was held on February 14, 2008.

The stockholders voted on proposals (1) to elect two Class II directors and (2) to ratify the Audit Committee of our Board of Directors' selection of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending September 30, 2008.

Both nominees for election to the Board as Class II directors were elected to serve until the Annual Meeting of Stockholders in 2011 or until their respective successors have been duly elected and qualified, or until the earlier of the director's death, resignation or retirement. The stockholders also ratified the selection by the Audit Committee of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending September 30, 2008.

The number of votes cast for, against or withheld and the number of abstentions with respect to each proposal is set forth below:

Election of Directors

| Nominee | For | Against |
|--------------------|------------|---------|
| Jaime Mateus-Tique | 26,006,972 | 248,096 |
| Phillip A. Clough | 26,006,412 | 248,656 |

Ratification of Appointment

| | For | Against | Abstain |
|---|------------|---------|---------|
| Ratification of appointment of Ernst & Young LLP as independent registered public accounting firm for the fiscal year ending September 30, 2008 | 25,675,447 | 8,220 | 42,022 |

Item 6. Exhibits.

| Exhibit No. | Description |
|-------------|---|
| 3.1 | Fourth Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on January 17, 2006. |
| 3.2 | Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.2 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on January 17, 2006. |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on May 9, 2008.

LIQUIDITY SERVICES, INC.
(Registrant)

By: /s/ William P. Angrick, III
William P. Angrick, III
*Chairman of the Board of Directors
and Chief Executive Officer*

By: /s/ James M. Rallo
James M. Rallo
Chief Financial Officer and Treasurer