BLUEFLY INC
Form 10-Q
August 13, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

|X| QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2002

|_| TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission File Number: 001-14498

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BLUEFLY, INC.
(Name of registrant as specified in its charter)

| Delaware | 13-3612110 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 42 West 39th Street, New York, NY | 10018 |
| (Address of principal executive offices) | (Zip Code) |

Issuer's telephone number: (212) 944-8000

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Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 |X| No |_|

As of August 12, 2002, the issuer had outstanding 10,391,904 shares of Common Stock, $.01 par value.

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Part I - FINANCIAL INFORMATION

Item 1. - Financial Statements

BLUEFLY, INC.

CONSOLIDATED BALANCE SHEETS

ASSETS

Current assets

Cash and cash equivalents

Inventories, net

Accounts receivable

Prepaid expenses

Other current assets

Total current assets

Property and equipment, net

Other assets

Total assets

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities
Accounts payable
Accrued expenses and other current liabilities
Deferred revenue

Total current liabilities

Note payable to shareholders

Long-term lease liability

Commitments and contingencies

Shareholders' equity
Series A Preferred stock - $.01 par value; 500,000 shares authorized and 500,000 shares issued and outstanding as of June 30, 2002 and December 31, 2001, respectively (liquidation preference: $10 million plus accrued dividends)
Series B Preferred stock - $.01 par value; 9,000,000 shares authorized and 8,910,782 shares issued and outstanding as of June 30, 2002 and December 31, 2001, respectively (liquidation preference: $30 million plus accrued dividends)
Common stock - $.01 par value; 40,000,000 shares authorized and 10,391,904 and 9,205,331 shares issued and outstanding as of June 30, 2002 and December 31, 2001, respectively
Additional paid-in capital
Accumulated deficit

Total shareholders' equity

Total liabilities and shareholders' equity

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



BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Six |
|---|---|
| | 2002 |
| Net sales | $ 14,445,000 |

| | |
|---|---|
| Cost of sales | 9,538,000 |
| Gross profit | 4,907,000 |
| Selling, marketing and fulfillment expenses | 5,066,000 |
| General and administrative expenses | 2,298,000 |
| Total | 7,364,000 |
| Operating loss | (2,457,000 |
| Interest income | 49,000 |
| Interest expense (the six months ended June 30, 2001, includes a $13,007,000 non-cash charge in connection with the conversion of debt and redeemable preferred equity to permanent equity) | (176,000 |
| Net loss | $ (2,584,000 |
| Deemed dividend related to beneficial conversion feature on Series B Preferred Stock | (10,226,000 |
| Preferred stock dividends | (1,224,000 |
| Net loss applicable to common shareholders | $(14,034,000 |
| Basic and diluted loss per common share | $ (1.48 |
| Weighted average common shares outstanding (basic and diluted) | 9,454,446 |

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



BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended June 30, | |
|---|---|---|
| | 2002 | 2001 |
| Net sales | $ 6,799,000 | $ 5,285,000 |
| Cost of sales | 4,392,000 | 3,561,000 |
| Gross profit | 2,407,000 | 1,724,000 |
| Selling, marketing and fulfillment expenses | 2,645,000 | 4,535,000 |
| General and administrative expenses | 1,221,000 | 1,387,000 |

| | | |
|---|---|---|
| Total | 3,866,000 | 5,922,000 |
| Operating loss | (1,459,000) | (4,198,000) |
| Interest income | 17,000 | 85,000 |
| Interest expense | (77,000) | (55,000) |
| Net loss | $ (1,519,000) | $(4,168,000) |
| Deemed dividend related to beneficial conversion feature on Series B Preferred Stock | (10,226,000) | -- |
| Preferred stock dividends | (615,000) | (615,000) |
| Net loss applicable to common shareholders | $(12,360,000) | $(4,783,000) |
| Basic and diluted loss per common share | $ (1.27) | $ (0.52) |
| Weighted average common shares outstanding (basic and diluted) | 9,700,823 | 9,205,331 |

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



BLUEFLY, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND REDEEMABLE PREFERRED STOCK
YEAR ENDED DECEMBER 31, 2001 AND FOR THE SIX MONTHS ENDED JUNE 30, 2002 (Unaudited)

| | Redeemable Preferred Stock | | Series A Preferred Stock $.01 par value | |
|---|---|---|---|---|
| | Number of shares | Amount | Number of shares | Amount |
| Balance at January 1, 2001 | 500,000 | $ 11,088,000 | -- | $ -- |
| Conversion of Redeemable Preferred Stock to Preferred Stock Series A | (500,000) | (11,088,000) | 500,000 | 5,000 |
| Conversion of debt to Preferred Stock Series B | -- | -- | -- | -- |
| Sale of common stock in connection with Rights Offering ($2.34 per share) net of $350,000 of expenses | -- | -- | -- | -- |
| Issuance of warrants to lender | -- | -- | -- | -- |
| Issuance of warrants in exchange for services | -- | -- | -- | -- |

| | | | | |
|---|---|---|---|---|
| Issuance of warrants to investor | -- | -- | -- | -- |
| Net loss | -- | -- | -- | -- |
| Balance at December 31, 2001 | -- | -- | 500,000 | 5,000 |
| Sale of common stock in connection with the Standby Commitment Agreement ($1.57 per share) net of $75,000 of expenses | -- | -- | -- | -- |
| Sale of warrants to investor in connection with the Standby Agreement | -- | -- | -- | -- |
| Deemed dividend related to beneficial conversion feature on Series B Preferred Stock | -- | -- | -- | -- |
| Issuance of warrants to lender | -- | -- | -- | -- |
| Issuance of warrants to investor | -- | -- | -- | -- |
| Net loss | -- | -- | -- | -- |
| Balance at June 30, 2002 | -- | $ -- | 500,000 | $5,000 |

| | Common Stock $.01 par value | | | |
|---|---|---|---|---|
| | Number of shares | Amount | Additional Paid-in capital | A |
| Balance at January 1, 2001 | 4,924,906 | $ 49,000 | $ 17,242,000 | $( |
| Conversion of Redeemable Preferred Stock to Preferred Stock Series A | -- | -- | 18,852,000 | |
| Conversion of debt to Preferred Stock Series B | -- | -- | 26,318,000 | |
| Sale of common stock in connection with Rights Offering ($2.34 per share) net of $350,000 of expenses | 4,280,425 | 43,000 | 9,622,000 | |
| Issuance of warrants to lender | -- | -- | 45,000 | |
| Issuance of warrants in exchange for services | -- | -- | 31,000 | |
| Issuance of warrants to investor | -- | -- | 74,000 | |
| Net loss | -- | -- | -- | ( |
| Balance at December 31, 2001 | 9,205,331 | 92,000 | 72,184,000 | ( |
| Sale of common stock in connection with the Standby Commitment Agreement ($1.57 per share) net of $75,000 of expenses | 1,186,573 | 12,000 | 1,776,000 | |
| Sale of warrants to investor in connection with the Standby Agreement | -- | -- | 37,000 | |
| Deemed dividend related to beneficial conversion feature on Series B Preferred Stock | -- | -- | 10,226,000 | ( |
| Issuance of warrants to lender | -- | -- | 80,000 | |
| Issuance of warrants to investor | -- | -- | 255,000 | |

| | | | | |
|---|---|---|---|---|
| Net loss | -- | -- | -- | -- |
| Balance at June 30, 2002 | 10,391,904 | $ 104,000 | $ 84,558,000 | $( |

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



BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | S |
|---|---|
| | 200 |
| Cash flows from operating activities | |
| Net loss | $ (2,58 |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation and amortization | 44 |
| Warrants issued for services | |
| Beneficial conversion - interest expense | |
| Provisions for returns | (54 |
| Changes in operating assets and liabilities: | |
| (Increase) decrease in | |
| Inventories | (1,75 |
| Accounts receivable | 5 |
| Prepaid expenses | (22 |
| Other current assets | 2 |
| Other assets | |
| Increase (decrease) in | |
| Accounts payable | 82 |
| Accrued expenses and other current liabilities | (5 |
| Deferred revenue | (11 |
| Net cash used in operating activities | (3,92 |
| Cash flows from investing activities | |
| Purchase of property, equipment and capitalized software | (1,28 |
| Net cash used in investing activities | (1,28 |
| Cash flows from financing activities | |
| Net proceeds from sale of Common Stock and Warrants | 1,89 |
| Payments of capital lease obligation | (9 |
| Net proceeds from Rights Offering | |

| | |
|---|---|
| Net cash provided by financing activities | 1,80 |
| Net (decrease) increase in cash and cash equivalents | (3,40 |
| Cash and cash equivalents - beginning of period | 5,41 |
| Cash and cash equivalents - end of period | $ 2,01 |
| Supplemental schedule of non-cash investing and financing activities: | |
| Equipment acquired under capital lease | $ 55 |
| Warrant issued to factor | $ 8 |
| Warrant issued to shareholder | $ 29 |
| Deemed dividend related to beneficial conversion feature on Series B Preferred Stock | $ 10,22 |
| Beneficial conversion charge on conversion of debt to equity | $ |

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



BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2002

NOTE 1 - BASIS OF PRESENTATION

The accompanying consolidated financial statements include the accounts of Bluefly, Inc. and its wholly owned subsidiary (collectively the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company's Form 10-K for the year ended December 31, 2001.

The Company has sustained net losses and negative cash flows from operations since the establishment of Bluefly.com. The Company's ability to meet its obligations in the ordinary course of business is dependent on its ability to establish profitable operations or raise additional financing through public or private debt or equity financing, or other sources to fund operations. The Company may seek additional equity or debt financing to maximize the growth of its business or if anticipated operating results are not achieved. If such financings are not available on terms acceptable to the Company, the Company will seek to delay or reduce its expenditures in order to prolong the availability of sufficient cash flow to satisfy its obligations while additional funding is sought. The inability to obtain additional financing, when needed,

would have a material adverse effect on the Company's business, prospects, financial condition and results of operations.

NOTE 2 - THE COMPANY

The Company is a leading Internet retailer of designer fashions and home accessories at outlet store prices. The Company's Web store ("Bluefly.com" or "Web Site"), which was launched in September 1998, sells over 400 brands of designer apparel, accessories and home products at discounts up to 75% off retail prices.

NOTE 3 - STANDBY COMMITMENT

On March 27, 2002, the Company entered into a Standby Commitment Agreement (the "Soros Standby Agreement") with Quantum Industrial Partners LDC, a Cayman Islands limited duration company ("QIP"), and SFM Domestic Investments LLC, a Delaware limited liability company ("SFMDI", QIP and SFMDI are each affiliates of Soros Private Equity Partners LLC and are collectively and individually sometimes referred to as "Soros"). Under the Soros Standby Agreement, Soros agreed to provide the Company with up to four million dollars ($4,000,000) of additional financing on a standby basis at any time prior to January 1, 2003.

In June 2002, Soros invested $1.9 million in the Company, thereby reducing its standby commitment to $2.1 million. Under the terms of the transaction, the Company issued 1,186,573 shares of Common Stock at $1.57 per share, and warrants to purchase 296,644 shares of Common Stock at any time during the next five years at an exercise price of $1.88 per warrant for a purchase price of $0.125 per warrant.

The June 2002 Soros investment was negotiated as part of an equity financing in which third party investors would also participate. In particular, one third party investor committed to invest $7 million on the same terms and conditions as those that applied to Soros' investment. However, this third party investment has not been consummated, and the Company does not know when or if it will be consummated. To date, the only funds that the Company has received from the third party investor are a $140,000 good faith deposit, for which the Company has agreed, for a limited period of time, not to pursue remedies against the third party investor as a result of its failure to honor its investment commitment. The Company believes that the third party investor's obligations to consummate the investment are enforceable. However, in the event that the third party investor does not honor its obligations, the Company will be forced to resort to litigation, which is subject to inherent risks and uncertainties. Moreover, given the substantial costs involved with litigation, there can be no assurance that the amount that the





Company would be able to collect with respect to any judgment rendered in such litigation would exceed the costs associated with obtaining such judgment.

In connection with the June 2002 financing, the Company agreed to file a registration statement with the Securities and Exchange Commission within 45 days of closing, in order to register the Common Stock issued in the financing, as well as the Common Stock underlying the warrants. However, given the failure to date of the third party investors to consummate their investment, the Company and Soros have agreed to delay the filing of such registration statement,

although the Company expects that it will be required to file such registration statement at some point in the future.

As a result of the June 2002 financing, the conversion price of the Company's Series B Preferred Stock, almost all of which is held by Soros, automatically decreased from $2.34 to $1.57. In accordance with FASB Emerging Issue Task Force Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," ("EITF 00-27") this reduction in the conversion price of the Company's Series B Preferred Stock resulted in the Company recording a beneficial conversion feature in the approximate amount of $10.2 million as part of its second quarter financial results. This non-cash charge, which is analogous to a dividend, resulted in an adjustment to the Company's computation of Loss Per Share.

In August 2002, Soros invested an additional $2.1 million in the Company, thereby reducing its standby commitment to zero. Under the terms of the deal, the Company issued to Soros 2,100 shares of its newly-designated Series 2002 Convertible Preferred Stock at a price of $1,000 per share. The Series 2002 Convertible Preferred Stock has a liquidation preference of $1,000 per share and is convertible in whole or in part, at the holder's option, into the type of equity securities sold by the Company in any subsequent round of equity financing, at the same price, and upon the same terms and conditions, as such securities are sold in such equity financing. Of course, there can be no assurance as to when, or, if, such subsequent round of financing will occur. The Series 2002 Convertible Preferred Stock does not have any fixed dividend rate, and does not provide the holders thereof with any voting rights, other than with respect to transactions or actions that would adversely affect the rights, preference, powers and privileges of the Series 2002 Convertible Preferred Stock.

NOTE 4 - FINANCING AGREEMENT

On March 22, 2002, the Company amended its Financing Agreement (the "Rosenthal Financing Agreement") with Rosenthal & Rosenthal, Inc. ("Rosenthal"), pursuant to which Rosenthal provides the Company with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to its suppliers (the "Loan Facility"). Under the terms of this amendment (the "Rosenthal Amendment"), the Company extended the Rosenthal Financing Agreement until March 30, 2003, reduced the annual fee it pays Rosenthal for the Loan Facility from $20,000 to $10,000, agreed to a decrease from $2.5 million to $1.5 million in the face amount of the standby letter of credit that Soros is maintaining (the "Soros Guarantee") to help collateralize the Loan Facility, and limited the maximum amount available under the Loan Facility to an amount equal to the Soros Guarantee plus the lowest of (x) $1 million, (y) 20% of the book value of the Company's inventory or (z) the full liquidation value of the Company's inventory. In addition, pursuant to the Rosenthal Amendment, the Company adjusted the threshold amount that entitles Rosenthal to take control of certain of the Company's cash accounts for a period of time to be 90% of the maximum amount available under the Loan Facility instead of 90% of the Soros Guarantee, as had been provided previously. As of June 30, 2002, the maximum amount available under the Loan Facility was $2.5 million. The Company had approximately $2.4 million outstanding as of such date.

As partial consideration for the Rosenthal Amendment, the Company extended from March 30, 2006 to March 30, 2007 the termination date of the warrant issued to Rosenthal on March 30, 2001 to purchase 50,000 shares of Common Stock at an exercise price of $2.34 per share. The Company revalued the warrant as of the new measurement date, using the Black-Scholes option pricing model and credited additional paid-in capital for approximately $80,000. This amount is being amortized over the life of the Loan Facility.

On March 22, 2002, in connection with the Rosenthal Amendment, the Company amended the Reimbursement Agreement (the "Reimbursement Agreement") pursuant to which Soros agreed to guarantee a portion of the Loan Facility to reduce the total amount of standby letters of credit that Soros is obligated to issue to collateralize the Loan Facility to $1.5 million from $4





million. The Company is obligated to reimburse Soros for any amounts it pays to Rosenthal pursuant to the Reimbursement Agreement. The Company's obligation to Rosenthal is collateralized by a lien on substantially all of its assets and it has granted Soros a subordinated lien on substantially all of its assets, including its cash balances, in order to collateralize the reimbursement obligations of Soros. In exchange for Soros' agreement to maintain the amended Soros Guarantee until August 15, 2003, the Company issued to Soros a warrant to purchase 60,000 shares of its Common Stock at an exercise price of $1.66 per share (the 20 day trailing average of the closing sale price of its Common Stock on the date of issuance), exercisable at any time until March 30, 2007. The Company valued the warrant using the Black-Scholes option pricing model and credited additional paid-in capital for approximately $98,000. This amount is being amortized over the life of the Loan Facility.

NOTE 5 - LOSS PER SHARE

The Company has determined Loss Per Share in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share." Basic loss per share excludes dilution and is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period.

Diluted loss per share is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period, adjusted to reflect potentially dilutive securities. Due to the loss from continuing operations, the following options and warrants to purchase shares of Common Stock and Preferred Stock convertible into shares of Common Stock were not included in the computation of diluted loss per share because the result of the exercise of such inclusion would be antidilutive:

| Security | June 30, 2002 | June 30, 2001 |
|---|---|---|
| Options | 3,863,078 | 4,859,062 |
| Warrants | 1,069,144 | 573,000 |
| Preferred Stock | 17,554,542 | 13,184,286 |

NOTE 6 - RECLASSIFICATIONS

Certain amounts in the consolidated financial statements of the prior period have been reclassified to conform to the current period presentation for comparative purposes.

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

Overview

Bluefly, Inc. is a leading Internet retailer of designer fashions and home accessories at outlet store prices. We sell over 400 brands of designer apparel, accessories and home products at discounts up to 75% off retail prices. We were incorporated in 1991 under the laws of the state of New York as Pivot Corporation. In 1994, we changed our name to Pivot Rules, Inc. We had our initial public offering in May of 1997. In June 1998, we discontinued our golf sportswear line to devote our time and resources to building Bluefly.com, a Web site to sell end-of-season and excess inventory of apparel and accessories. We launched the Web site in September 1998 and changed our name to Bluefly, Inc. in October 1998. In February 2001, we changed our state of incorporation from New York to Delaware.

We have grown rapidly since launching our Web site in September 1998. Our net sales increased approximately 29% to $6,799,000 for the three months ended June 30, 2002 from $5,285,000 for the three months ended June 30, 2001. In addition, our net loss for the second quarter of 2002 decreased to $1,519,000 from $4,168,000 in the second quarter of 2001. The decrease in the net loss for the second quarter of 2002 was due to an increase in gross profit and a decrease in both selling, marketing and fulfillment expenses and general and administrative expenses both on an absolute basis, and as a percentage of revenue.





At June 30, 2002 we had an accumulated deficit of $76,778,000. Historical net losses and the accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site and building our infrastructure. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore expect to continue to incur substantial operating losses at least until the fourth quarter of 2002. We expect to be profitable in the fourth quarter of 2002. However, we anticipate losses in the first two quarters of 2003 and perhaps beyond. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

Significant Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to the adequacy of the allowances for returns and recoverability of inventories. Actual amounts could differ significantly from these estimates.

Revenue Recognition

Gross sales consist primarily of revenue from product sales and shipping and handling revenue on our Web site, and is net of promotional discounts. Revenue is recognized when goods are received by our customers, which occurs only after credit card authorization. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes.

Provision for Returns and Doubtful Accounts

We generally permit returns for any reason within 90 days of the sale.

Accordingly, we establish a reserve for estimated future returns and bad debt at the time of shipment based primarily on historical data. However, our future return and bad debt rates could differ significantly from historical patterns, which would adversely affect our operating results.

Inventory Valuation

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. We review our inventory levels in order to identify slow-moving merchandise and use markdowns to clear merchandise. Markdowns may be used if inventory exceeds customer demand for reasons of style, changes in customer preference or lack of consumer acceptance of certain items, or if it is determined that the inventory in stock will not sell at its currently marked price. Such markdowns may have an adverse impact on earnings, depending on the extent of the markdowns and amount of inventory affected.

Tax Valuation Allowance

We assessed the future taxable income and have determined that a 100% deferred tax valuation allowance is deemed necessary. In the event that we were to determine that we would be able to realize our deferred tax asset, an adjustment to the deferred tax value allowance would increase income in the period such determination is made.

Results Of Operations

The following table sets forth our statement of operations data, for the three months ended June 30th. All data in thousands except as indicated below:



BLUEFLY, INC.
JUNE 30, 2002

| | 2002 | | 2001 | |
|---|---|---|---|---|
| | | As a % of Net Sales | | As a Net S |
| Net sales | $6,799 | 100.0% | $5,285 | 100. |
| Cost of sales | 4,392 | 64.6% | 3,561 | 67. |
| Gross profit | 2,407 | 35.4% | 1,724 | 32. |
| Selling, marketing and fulfillment expenses | 2,645 | 38.9% | 4,535 | 85. |
| General and administrative expenses | 1,221 | 18.0% | 1,387 | 26. |
| Total operating expenses | 3,866 | 56.9% | 5,922 | 112. |
| Operating loss from continuing operations | (1,459) | (21.5)% | (4,198) | (79. |
| Interest (expense) and other income | (60) | (0.9)% | 30 | 0. |
| Net loss | (1,519) | (22.4)% | (4,168) | (78. |

We also measure and evaluate ourselves against certain other key operational

metrics. The following table sets forth our actual results based on these other metrics for the three months ended June 30th, as indicated below:

| | 2002 | 2 |
|---|---|---|
| Average Order Size (including shipping & handling) | $ 161.65 | $ 140 |
| Average Order Size Per New Customer (including shipping & handling) | $ 149.01 | $ 125 |
| Average Order Size Per Repeat Customer (including shipping & handling) | $ 167.80 | $ 154 |
| Registered Users | 1,269,948 | 1,001, |
| Registered Users Added During the Period | 76,060 | 138, |
| Total Customers | 333,567 | 235, |
| Customers Added during the Period | 21,057 | 25, |
| Revenue from Repeat Customers as a % of total Revenue | 70% | |
| Customer Acquisition Costs | $ 16.92 | $ 75 |

We define a "repeat customer" as a person who has bought more than once from us during their lifetime. We calculate customer acquisition cost by dividing total advertising expenditures (excluding staff related costs) during a given time period by total new customers added during that period. All measures of the number of customers are based on unique email addresses.

For The Six Months Ended June 30, 2002 Compared To The Six Months Ended June 30, 2001

Net sales: Gross sales for the six months ended June 30, 2002, increased by 56% to $22,089,000, from $14,144,000 for the six months ended June 30, 2001. For the six months ended June 30, 2002, we recorded a provision for returns and credit card chargebacks and other discounts of $7,644,000, or approximately 34.6% of gross sales. For the six months ended June 30, 2001, the provision for returns and credit card chargebacks and other discounts was $4,213,000 or approximately 29.8% of gross sales. The increase in this provision as a percentage of gross sales is related primarily to an increase in the return rate. We believe that the increase in return rate is partly the result of a shift in our merchandise mix towards certain product categories that historically have generated higher return rates, but also higher gross margins.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the six months ended June 30, 2002 were $14,445,000. This represents an increase of 45% compared to the six months ended June 30,





2001, in which net sales totaled $9,931,000. The growth in net sales was largely driven by the increases in average order size and sales to repeat customers, as illustrated by the fact that the number of new customers acquired in the first six months of 2002 decreased from that of the first six months of 2001. The increase in average order size, we believe, is related to changes in our product mix, which is now focused on higher priced goods. We believe that the increase in sales to repeat customers and the decline in the number of new customers was the result of increased marketing efforts to repeat customers and a reduction in the amount of advertising we do that is directed to new customers.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the six months ended June 30, 2002 totaled $9,538,000, resulting in gross margin of approximately 34%. Cost of sales for the six months ended June 30, 2001 totaled $6,924,000, resulting in gross margin of 30%. Gross profit increased by 63%, to $4,907,000 for the six months ended June 30, 2002 compared to $3,007,000 for the six months ended June 30, 2001. The increase in gross margin resulted primarily from improved product margins.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses decreased by approximately 37% in the first six months of 2002 compared to the first six months of 2001. Selling, marketing and fulfillment expenses were comprised of the following:

| | Six Months Ended June 30, 2002 | Six Months Ended June 30, 2001 | Percentage Difference increase (decrease) |
|---|---|---|---|
| Marketing | $ 869,000 | $ 3,410,000 | (74.5%) |
| Operating | 2,121,000 | 1,783,000 | 19.0% |
| Technology | 1,580,000 | 2,172,000 | (27.3%) |
| Creative Services | 496,000 | 711,000 | (30.2%) |
| | $5,066,000 | $ 8,076,000 | (37.3%) |

Marketing expenses include expenses related to online and print advertising, direct mail campaigns as well as staff related costs. The decrease in marketing expenses of approximately 75% is largely related to a shift in our customer acquisition strategy. Consistent with our streamlined operating plan announced in June 2001, we significantly reduced our advertising expenditures and focused more on email and direct mail programs. Primarily as a result of this shift, we were able to decrease our customer acquisition costs for the six months ended June 30, 2002 by approximately 78% to $12.85 per customer from $58.72 per customer for the six months ended June 30, 2001.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in the first six months of 2002 by approximately 19% compared to the first six months of 2001. Variable costs associated with the increased sales volume (picking and packing orders, processing returns and credit card fees) increased in connection with the increase in gross sales.

Technology expenses consist primarily of Web site hosting and staff related costs. For the six months ended June 30, 2002 technology expenses decreased by approximately 27% compared to the six months ended June 30, 2001. This reduction is primarily related to a reduction in our Web site hosting costs in connection with our move to a new web hosting facility. We are currently developing an upgraded version of our Web site based on Blue Martini software. Costs directly associated with this project are being capitalized and will be amortized after the new site has been launched, over the useful life of the new site.

Creative services expenses include expenses related to our photo studio, image processing, and Web site design. For the six months ended June 30, 2002, this amount decreased by approximately 30% as compared to the six months ended June 30, 2001, primarily due to a headcount reduction in the creative services department in June 2001.

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BLUEFLY, INC.
JUNE 30, 2002

As a percentage of net sales, our selling, marketing and fulfillment expenses decreased to 35% in the first six months of 2002 from 81% in the first six months of 2001. The decrease resulted primarily from a more targeted marketing strategy aimed at our existing customer base and the cost savings we derived from our move to a new web hosting facility.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the six months ended June 30, 2002 decreased by approximately 24% to $2,298,000 as compared to $3,038,000 for the six months ended June 30, 2001. The decrease in general and administrative expenses was largely the result of decreased salary and benefit expenses related to the headcount reduction that was put into place in connection with the Company's June 2001 streamlined operating plan. The number of employees categorized as general and administrative for the six months ended June 30, 2002 was 23, compared to 31 for the six months ended June 30, 2001.

As a percentage of net sales, general and administrative expenses decreased to 16% in 2002 from 31% in 2001.

Loss from operations: Operating loss decreased by almost 70% in the first six months of 2002 to $2,457,000 from $8,107,000 in the first six months of 2001 as a result of the increase in gross margin and decreases, on an absolute basis and as a percentage of net sales, in selling, marketing and fulfillment expenses and general and administrative expenses.

Interest expense and other income, net: Interest expense for the six months ended June 30, 2002 totaled $176,000, and related primarily to fees paid in connection with our Loan Facility. For the six months ended June 30, 2001, interest expense totaled $13,240,000. This amount consisted principally of approximately $13,007,000 of non-cash, one-time charges that were incurred in connection with the conversion of certain notes payable and redeemable equity into permanent equity. This amount also included interest expense of $175,000, related to the interest on the notes payable that were issued during fiscal 2000 and converted to permanent equity in fiscal 2001.

Interest income for the six months ended June 30, 2002 decreased to $49,000 from $148,000 for the six months ended June 30, 2001. The decrease is related to the decrease in our cash balance as interest income primarily represents interest earned on our cash balance.

For The Three Months Ended June 30, 2002 Compared To The Three Months Ended June 30, 2001

Net sales: Gross sales for the three months ended June 30, 2002, increased by 41% to $10,747,000, from $7,631,000 for the three months ended June 30, 2001. For the three months ended June 30, 2002, we recorded a provision for returns and credit card chargebacks and other discounts of $3,948,000, or approximately 36.7% of gross sales. For the three months ended June 30, 2001, the provision for returns and credit card chargebacks and other discounts was $2,346,000 or approximately 30.7% of gross sales. The increase in this provision as a percentage of gross sales is related primarily to an increase in the return rate. We believe that the increase in return rate is partly the result of a shift in our merchandise mix towards certain product categories that historically have generated higher return rates, but also higher gross margins.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the three months ended June 30, 2002 were $6,799,000. This represents an increase of 29% compared to the three months ended June 30, 2001, in which net sales totaled $5,285,000. The growth in net sales was largely driven by the increases in average order size and sales to repeat customers, as illustrated by the fact that the number of new customers acquired in the second quarter of 2002 decreased from that of the second quarter of 2001. The increase in average order size, we believe, is related to changes in our product mix, which is now focused on higher priced goods. We believe that the increase in sales to repeat customers and the decline in the number of new customers was the result of increased marketing efforts to repeat customers and a reduction in the amount of advertising we do that is directed to new customers.

Cost of sales: Cost of sales for the three months ended June 30, 2002 totaled $4,392,000, resulting in gross margin of over 35%. Cost of sales for the three months ended June 30, 2001 totaled $3,561,000, resulting in gross margin of approximately 33%. Gross





profit increased by almost 40%, to $2,407,000 for the three months ended June 30, 2002 compared to $1,724,000 for the three months ended June 30, 2001. The increase in gross margin resulted primarily from improved product margins.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses decreased by approximately 42% in the second quarter of 2002 compared to the second quarter of 2001. Selling, marketing and fulfillment expenses were comprised of the following:

| | Three Months Ended June 30, 2002 | Three Months Ended June 30, 2001 | Percentage Difference increase (decrease) |
|---|---|---|---|
| Marketing | $ 507,000 | $ 2,206,000 | (77.0%) |
| Operating | 1,070,000 | 918,000 | 16.6% |
| Technology | 810,000 | 1,041,000 | (22.2%) |
| Creative Services | 258,000 | 370,000 | (30.3%) |
| | $2,645,000 | $ 4,535,000 | (41.7%) |

The decrease in marketing expenses of 77% is largely related to the shift in our customer acquisition strategy discussed above. Primarily as a result of this shift, we were able to decrease our customer acquisition costs for the three months ended June 30, 2002 by almost 78% to $16.92 per customer from $75.40 per customer for the three months ended June 30, 2001.

Operating expenses increased in the second quarter of 2002 by approximately 17% compared to the second quarter of 2001. Variable costs associated with the increased sales volume (picking and packing orders, processing returns and credit card fees) increased in connection with the increase in gross sales.

For the three months ended June 30, 2002 technology expenses decreased by

approximately 22% compared to the three months ended June 30, 2001. This reduction is primarily related to a reduction in our Web site hosting costs in connection with our move to a new web hosting facility.

For the second quarter of 2002, this amount decreased by approximately 30% as compared to the first quarter of 2001, primarily due to a headcount reduction in the creative services department in June 2001.

As a percentage of net sales, our selling, marketing and fulfillment expenses, decreased to 39% in the second quarter of 2002 from 86% in the second quarter of 2001. The decrease resulted primarily from a more targeted marketing strategy aimed at our existing customer base and the cost savings we derived from our move to a new web hosting facility.

General and administrative expenses: General and administrative expenses for the three months ended June 30, 2002 decreased by approximately 12% to $1,221,000 as compared to $1,387,000 for the three months ended June 30, 2001. The decrease in general and administrative expenses was largely the result of decreased salary and benefit expenses related to the headcount reduction that was put into place in connection with the Company's June 2001 streamlined operating plan. The number of employees categorized as general and administrative for the three months ended June 30, 2002 was 22, compared to 32 for the three months ended June 30, 2001.

As a percentage of net sales, general and administrative expenses decreased to 18% in 2002 from 26% in 2001.

Loss from operations: Operating loss decreased by almost 65% in the second quarter of 2002 to $1,459,000 from $4,198,000 in the second quarter of 2001 as a result of the increase in gross margin and decreases, as a percentage of net sales, in selling, marketing and fulfillment expenses and general and administrative expenses.





Interest expense and other income, net: Interest expense for the three months ended June 30, 2002 totaled $77,000 and $55,000 for the three months ended June 30, 2001. Both periods of interest expense related primarily to fees paid in connection with our Loan Facility.

Interest income for the three months ended June 30, 2002 decreased to $17,000 from $85,000 for the three months ended June 30, 2001. The decrease is related to the decrease in our cash balance as interest income primarily represents interest earned on our cash balance.

Liquidity And Capital Resources

General

At June 30, 2002, the Company had approximately $2.0 million of liquid assets, entirely in the form of cash and cash equivalents, working capital of approximately $5.5 million and $2.1 million available under the Soros Standby Agreement. In addition, as of June 30, 2002, the Company had approximately $2.4 million of borrowings committed under the Loan Facility, leaving approximately $100,000 of availability. In August 2002, the Company received an additional $2.1 million under the Soros Standby Agreement as more fully described below, thus reducing Soros' standby commitment to zero.

We fund our operations through cash on hand, operating cash flow and the Loan Facility, as well as the proceeds of any equity financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance on these financial measures would have a negative impact on our liquidity. Total availability under the Loan Facility is based upon our inventory levels and dependent, among other things, on the Company having at least $1.5 million of tangible net worth and $3.5 million of working capital. In addition, both availability under the Loan Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Rosenthal to provide credit support under the Loan Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and financial press and elsewhere as to our financial strength. Accordingly, negative perceptions as to our financial strength could have a negative impact on our liquidity.

Loan Facility

Pursuant to the Rosenthal Financing Agreement, as amended, Rosenthal provides us with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to our suppliers. The maximum amount available under the Loan Facility is an amount equal to the amount of Soros Guarantee (currently $1.5 million) plus the lowest of (x) $1 million, (y) 20% of the book value of our inventory and (z) the full liquidation value of our inventory. However, the maximum availability under the Loan Facility can never exceed $10 million. Under the Loan Facility, we are required to have at least $1,500,000 of tangible net worth and $3,500,000 of working capital. Interest accrues monthly on the average daily amount outstanding under the Loan Facility during the preceding month at a per annum rate equal to the prime rate plus 1%. As of June 30, 2002, maximum availability under the Loan Facility was approximately $2.5 million. The Company had approximately $2.4 million outstanding as of such date.

We also pay Rosenthal (a) an annual facility fee equal to a certain percentage of the maximum inventory facility available under the Loan Facility and (b) certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit or guarantee plus, a certain percentage of the face amount of such letters of credit or guarantees for each thirty (30) days or a portion thereof that such letters of credit or guarantees are open.

In consideration for the Loan Facility, among other things, we granted to Rosenthal a first priority lien on substantially all of our assets, including control of all of our cash accounts upon an event of default and certain of our cash accounts in the event that the total amount of monies loaned to us under the Loan Facility exceeds 90% of the maximum amount available under the Loan





Facility for more than 10 days. We also issued to Rosenthal on March 31, 2001 a warrant to purchase 50,000 shares of our Common Stock at an exercise price of $2.34 exercisable, as amended, for six years from the date of issuance.

In connection with the Loan Facility, we entered into a Reimbursement Agreement

with Soros pursuant to which Soros issued a standby letter of credit at closing (the "Soros Guarantee") in the amount of $2.5 million in favor of Rosenthal to guarantee a portion of the Company's obligations under the Rosenthal Financing Agreement, we agreed to reimburse Soros for any amounts it pays to Rosenthal pursuant to such guarantee and we granted Soros a subordinated lien on substantially all of our assets, including our cash balances, in order to secure our reimbursement obligations. In connection with the recent amendment of the Rosenthal Financing Agreement, the face amount of the Soros Guarantee was reduced from $2.5 to $1.5 million, Soros' obligation to issue at our request another standby letter of credit for up to an additional $1.5 million was terminated and Soros agreed to maintain the Soros Guarantee until August 15, 2003. In consideration for the issuance of the original Soros Guarantee, we issued to Soros a warrant to purchase 100,000 shares of our Common Stock at an exercise price equal to $0.88, exercisable at any time prior to September 15, 2011. In consideration for Soros' agreement to maintain the amended Soros Guarantee until August 15, 2003, we issued to Soros a warrant to purchase 60,000 shares of our Common Stock at an exercise price equal to $1.66 per share (the 20 day trailing average of the closing sale price of our Common Stock on the date of issuance), exercisable at any time prior to March 30, 2007.

Subject to certain conditions, if we default on any of our obligations under the Rosenthal Financing Agreement, Rosenthal has the right to draw upon the Soros Guarantee to satisfy any such obligations. If and when Rosenthal draws on the Soros Guarantee, pursuant to the terms of the Reimbursement Agreement, we would have the obligation to, among other things, reimburse Soros for any amounts drawn under the Soros Guarantee plus interest accrued thereon. In addition, to the extent that Rosenthal draws on the Soros Guarantee during the continuance of a default under the Rosenthal Financing Agreement or at any time that the total amount outstanding under the Loan Facility exceeds 90% of the Soros Guarantee, we will be required to issue to Soros a warrant (each a "Contingent Warrant") to purchase a number of shares of Common Stock equal to the quotient of (a) any amounts drawn under the Soros Guarantee and (b) 75% of the average of the closing price of our Common Stock on the ten days preceding the date of issuance of such warrant. Each Contingent Warrant will be exercisable for ten years from the date of issuance at an exercise price equal to 75% of the average closing price of our Common Stock on the ten days preceding the ten days after the date of issuance.

Under the Rosenthal Financing Agreement, Soros has the right to purchase all of our obligations from Rosenthal at any time during the term of the Rosenthal Financing Agreement. With respect to such Buyout Option, Soros has the right to request that Rosenthal make a draw under the Soros Guarantee as consideration to Soros for the purchase of such obligations.

Standby Commitment

On March 27, 2002, we entered into the Standby Commitment Agreement with Soros. Under the Soros Standby Agreement, Soros agreed to provide us with up to four million dollars ($4,000,000) of additional financing on a standby basis at any time prior to January 1, 2003. In exchange for this commitment, but not as a substitute for additional consideration that Soros would receive if and when any financing is made pursuant to the Soros Standby Agreement, we issued to Soros a warrant to purchase 100,000 shares of our Common Stock at an exercise price of $1.68 per share (the 20 day trailing average of the closing sale price of our Common Stock on the date of issuance), exercisable at any time until March 27, 2007. In connection with the issuance of this warrant, Soros agreed that the issuance of this warrant shall not trigger the anti-dilution provision contained in Section 5.8.6 of our Certificate of Incorporation.

In June 2002, Soros invested $1.9 million in us, thereby reducing its standby commitment to $2.1 million. Under the terms of the deal, we issued 1,186,573 shares of Common Stock at $1.57 per share, and warrants to purchase 296,644

shares of Common Stock at any time during the next five years at an exercise price of $1.88 per warrant for a purchase price of $0.125 per warrant.

The June 2002 Soros investment was negotiated as part of an equity financing in which third party investors would also participate. In particular, one third party investor committed to invest $7 million on the same terms and conditions as those that applied to Soros' investment. However, this third party investment has not been consummated, and we do not know when or if





it will be consummated. To date, the only funds that we have received from the third party investor are a $140,000 good faith deposit, for which we have agreed, for a limited period of time, not to pursue remedies against the third party investor as a result of its failure to honor its investment commitment. We believe that the third party investor's obligations to consummate the investment are enforceable. However, in the event that the third party investor does not honor its obligations, we will be forced to resort to litigation, which is subject to inherent risks and uncertainties. Moreover, given the substantial costs involved with litigation, there can be no assurance that the amount that we would be able to collect with respect to any judgment rendered in connection with such litigation would exceed the costs associated with obtaining such judgment.

In connection with the June 2002 financing, we agreed to file a registration statement with the Securities and Exchange Commission within 45 days of closing, in order to register the Common Stock issued in the financing, as well as the Common Stock underlying the warrants. However, given the failure to date of the third party investors to consummate their investment, Soros has agreed with us to delay the filing of such registration statement, although we expect that we will be required to file such registration statement at some point in the future.

As a result of the June 2002 financing, the conversion price of our Series B Preferred Stock, almost all of which is held by Soros, automatically decreased from $2.34 to $1.57. In accordance with EITF 00-27, this reduction in the conversion price of the Company's Series B Preferred Stock resulted in the Company recording a beneficial conversion feature in the approximate amount of $10.2 million as part of its second quarter financial results. This non-cash charge, which is analogous to a dividend, resulted in an adjustment to the Company's computation of (Loss)/Earnings Per Share.

In August 2002, Soros invested an additional $2.1 million in us, thereby reducing its standby commitment to zero. Under the terms of the deal, we issued to Soros 2,100 shares of our newly-designated Series 2002 Convertible Preferred Stock at a price of $1,000 per share. The Series 2002 Convertible Preferred Stock has a liquidation preference of $1,000 per share and is convertible in whole or in part, at the holder's option, into the type of equity securities sold by us in any subsequent round of equity financing, at the same price, and upon the same terms and conditions, as such securities are sold in such equity financing. The Series 2002 Convertible Preferred Stock does not have any fixed dividend rate, and does not provide the holders thereof with any voting rights, other than with respect to transactions or actions that would adversely affect the rights, preference, powers and privileges of the Series 2002 Convertible Preferred Stock.

Commitments And Long Term Obligations

As of June 30, 2002, we had the following commitments and long term obligations:

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| Marketing and Advertising | $ 213,000 | -- | -- | -- | -- |
| Operating Leases | $ 369,000 | 568,000 | 519,000 | 457,000 | 449,000 |
| Employment Contracts | $ 499,000 | 495,000 | 28,000 | -- | -- |
| Capital Leases | $ 86,000 | 159,000 | 159,000 | 55,000 | -- |
| Note payable to shareholder | $ -- | -- | -- | 182,000 | -- |
| Grand total | $1,167,000 | 1,222,000 | 706,000 | 694,000 | 449,000 |

On March 12, 2002, we entered into a Software License and Service Agreement with Blue Martini. In March 2002, with the assistance of consultants from Blue Martini, we began the development of an upgraded version of our Web site based on Blue Martini Software. Once launched, we expect that the new Web site will provide us with better tools to create and manage on-site marketing promotions, more robust analytical tools to measure the performance of on-site promotions, greater site stability, and a more efficient platform from which to scale our technology infrastructure should any future growth in our business dictate such a need. All costs associated with the upgraded site have been and will be accounted for in accordance with Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). We expect to launch the new Web site during the third quarter of 2002. Of course, there can be no assurance that the new Web site will be launched when scheduled, that there will not be start up problems associated with the launch or that our expectations as to the benefits of the





new Web site will prove to be correct or that they will have a positive effect on our business.

We believe that in order to grow the business, we will need to make additional marketing and advertising commitments in the future. In addition, we expect to hire and train additional employees for the operations and development of Bluefly.com. However, our marketing budget and our ability to hire such employees are subject to a number of factors, including our results of operations as well as the amount of additional capital that we raise.

In order to continue to expand our product offerings, we intend to expand our relationships with suppliers of end-of-season and excess name brand apparel and fashion accessories. We expect that our suppliers will continue to include designers and retail stores that sell excess inventory as well as third-party end-of-season apparel aggregators. To achieve our goal of offering a wide selection of top name brand designer clothing and fashion accessories, we may acquire certain goods on consignment and may explore leasing or partnering select departments with strategic partners and distributors. Due to our limited working capital, a number of our suppliers have limited our payment terms and, in some cases, have required us to pay for merchandise in advance of delivery.

Based on our current plans, we anticipate that the proceeds from the Rosenthal Financing Agreement together with existing resources and cash generated from

operations, should be sufficient to satisfy our cash requirements through the end of fiscal 2002. These plans anticipate that we will seek additional debt and/or equity financing in order to maximize the growth of our business. There can be no assurance that any additional financing or other sources of capital will be available to us upon acceptable terms, or at all. The inability to obtain additional financing would have a material adverse effect on our business, prospects, financial condition and results of operations. Moreover, to the extent that we determine that additional financing may not be available, we may be required to alter our current growth plans in order to preserve capital for use during 2003.

Recent Accounting Pronouncements

Financial Reporting Release No. 60, which was recently released by the Securities and Exchange Commission (the "Commission"), requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note 2 of the notes to the consolidated financial statements includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. For a brief discussion of the more significant accounting policies and methods used by us, please see, "Significant Accounting Policies."

In addition, Financial Reporting Release No. 61 was recently released by the Commission, and requires all companies to include a discussion addressing, among other things, liquidity, off balance sheet arrangements, contractual obligations and commercial commitments. For a discussion of these issues, please read "Liquidity and Capital Resources."

In April 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment to FASB Statement No. 13, and Technical Corrections" ("SFAS No. 145"). SFAS No. 145 eliminates the requirement (in SFAS No. 4) that gains and losses from the extinguishments of debt be aggregated and classified as extraordinary items, net of the related income tax. In addition, SFAS No. 145 requires sales-lease back treatment for certain modifications of a capital lease that result in the lease being classified as an operating lease. The rescission of SFAS No. 4 is effective for fiscal years beginning after May 15, 2002, which for the Company would be December 31, 2003. Earlier application is encouraged. Any gain or loss on extinguishment of debt that was previously classified as an extraordinary item would be reclassified to other income (expense). The remainder of the statement is generally effective for transactions occurring after May 15, 2002. We do not expect that the adoption of SFAS No. 145 will have a material impact on our financial condition, cash flows and results of operations.

In October 2001, the FASB issued Statement No. 144 ("SFAS No. 144"), "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of" and certain provisions of APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events





and Transactions," for the disposal of a segment of a business (as previously defined in that Opinion). The provisions of SFAS No. 144 are effective for

fiscal years beginning after December 15, 2001. We do not anticipate that the adoption of SFAS No. 144 will have a material impact on our consolidated financial statements.

In June 2001, the FASB issued Statement No. 143 ("SFAS No. 143"), "Accounting for Asset Retirement Obligations." SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 shall be effective for financial statements issued for fiscal years beginning after June 15, 2002. Earlier application is encouraged. Initial application of this Statement shall be as of the beginning of an entity's fiscal year. We do not anticipate that the adoption of SFAS No. 143 will have a material impact on our consolidated financial statements.

In July 2001, the FASB issued Statement No. 142 ("SFAS No. 142"), "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill and indefinite lived intangible assets will no longer be amortized, but rather will be tested for impairment within six months of adoption and at least annually thereafter effective for years beginning after December 15, 2001. In addition, the amortization period of intangible assets with finite lives will no longer be limited. We do not anticipate that the adoption of SFAS No. 142 will have a material impact on our consolidated financial statements.

In June 2001, the FASB issued Statement No. 141 ("SFAS No. 141"),"Business Combinations." SFAS No. 141 requires all business combinations initiated after June 30, 2001 be accounted for under the purchase method. In addition, SFAS No. 141 establishes criteria for the recognition and measurement of intangible assets separately from goodwill. SFAS No. 141 may require us to reclassify the carrying amounts of certain intangible assets into or out of goodwill, based upon certain criteria. We do not anticipate that the adoption of SFAS No. 141 will have a material impact on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We have assessed our vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and our notes payable. Due to the short-term nature of these investments we have determined that the risks associated with interest rate fluctuations related to these financial instruments do not pose a material risk to us.

Special Note Regarding Forward Looking Statements

This report may include statements that constitute "forward-looking" statements, usually containing the words "believe", "project", "expect", or similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements. The risks and uncertainties are detailed from time to time in reports filed by the company with the Securities and Exchange Commission, including Forms 8-A, 8-K, 10-Q, and 10-K. These risks and uncertainties include, but are not limited to, the following: the Company's limited working capital, need for additional capital and potential inability to raise such capital; potential dilution arising from future equity financings, including potential dilution as a result of the anti-dilution provisions contained in the Company's Series B Preferred Stock; the competitive nature of the business and the potential for competitors with greater resources to enter such business; adverse trends in the retail apparel market; the risk that recent favorable trends in sales, gross margin and reduced sales marketing and fulfillment expenses will not continue; risks of litigation for sale of unauthentic or damaged goods and litigation risks related to sales in foreign countries; availability formulas under the Rosenthal credit facility

which limit the amount of funds available for borrowing; the Company's potential inability to make repayments under the Rosenthal credit facility and the possible shareholder dilution that could result if the Soros standby letter of credit is drawn upon; the risk of default by the Company under the Rosenthal financing agreement and the consequences that might arise from the Company having granted a lien on substantially all of its assets under that agreement; consumer acceptance of the Internet as a medium for purchasing apparel; recent losses and anticipated future losses; the capital intensive nature of such business (taking into account the need for advertising to promote such business); the dependence on third parties and certain relationships for certain services, including the Company's dependence on the United States Postal Service and UPS (and





the risk of a mail slowdown due to terrorist activity) and the Company's dependence on third-party web hosting and fulfillment centers; the successful hiring and retaining of personnel; the dependence on continued growth of online commerce; rapid technological change; online commerce security risks; the startup nature of the Internet business; governmental regulation and legal uncertainties; management of potential growth; and unexpected changes in fashion trends.

## Part II - OTHER INFORMATION

### Item 1. Legal Proceedings

We currently and from time to time, are involved in litigation incidental to the conduct of our business. However we are not party to any lawsuit or proceeding which in the opinion of management is likely to have a material adverse effect on us.

### Item 2. Changes in Securities and Use Of Proceeds

In June 2002, the Company sold 1,186,573 shares of Common Stock and warrants to purchase 296,644 shares of Common Stock at an exercise price of $1.88 per share to Soros for aggregate consideration of $1.9 million.

In August 2002, the Company sold 2,100 shares of its newly-designated Series 2002 Preferred Stock to Soros for aggregate consideration of $2.1 million. The Series 2002 Preferred Stock has a liquidation preference of $1,000 per share and is convertible in whole or in part, at the holder's option, into the type of equity securities sold by us in any subsequent round of equity financing, at the same price, and upon the same terms and conditions, as such securities are sold in such equity financing.

The above-described sales were deemed to be exempt from registration under the Securities Act of 1933, as amended (the "Act") in reliance on Section 4(2) of the Act.

### Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) The following is a list of exhibits filed as part of this Report:

| Exhibit Number | Description |
| --- | --- |
| 3.3 | Certificate of Powers, Designations, Preferences and Rights of Series 2002 Preferred Stock of the Registrant |
| 10.39 | Common Stock and Warrant Purchase Agreement, dated May 24, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto |
| 10.40 | Series 2002 Preferred Stock Purchase Agreement, dated August 12, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto |





| Exhibit Number | Description |
| --- | --- |
| 99.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 99.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) Reports on Form 8-K:

The Company filed a report on Form 8-K, dated June 3, 2002 concerning an additional investment made by affiliates of Soros Private Equity Partners LLC in the Company.





SIGNATURES

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

BLUEFLY, INC.

By: /s/ E. Kenneth Seiff

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E. Kenneth Seiff
CEO and President

By: /s/ Patrick C. Barry
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Patrick C. Barry
Chief Financial Officer

August 12, 2002