OVERSTOCK.COM, INC
Form 10-Q
October 28, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

Or

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

For the transition period from to

Commission file number: 000-49799

OVERSTOCK.COM, INC.
(Exact name of registrant as specified in its charter)

Delaware	87-0634302
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
6350 South 3000 East, Salt Lake City, Utah 84121	(801) 947-3100
(Address, including zip code, of Registrant's principal executive offices)	(Registrant's telephone number, including area code)

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

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

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.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

There were 24,027,339 shares of the Registrant's common stock, par value $0.0001, outstanding on October 23, 2014.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

Overstock.com, Inc.
Consolidated Balance Sheets (Unaudited)
(in thousands)

	September 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$112,740	$148,665
Restricted cash	1,580	1,580
Accounts receivable, net	14,941	16,047
Inventories, net	25,283	27,043
Prepaid inventories, net	1,723	1,804
Deferred tax assets, net	13,733	13,733
Prepaids and other current assets	14,143	10,298
Total current assets	184,143	219,170
Fixed assets, net	47,622	27,194
Precious metals	8,926	9,678
Deferred tax assets, net	52,952	55,861
Goodwill	2,784	2,784
Other long-term assets, net	1,943	2,023
Total assets	$298,370	$316,710
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$63,141	$90,582
Accrued liabilities	62,370	65,679
Deferred revenue	40,651	37,321
Total current liabilities	166,162	193,582
Other long-term liabilities	3,888	3,294
Total liabilities	170,050	196,876
Commitments and contingencies (Note 5)	0	0
Stockholders' equity:		
Preferred stock, $0.0001 par value:		
Authorized shares - 5,000		
Issued and outstanding shares - none	—	—
Common stock, $0.0001 par value		
Authorized shares - 100,000		
Issued shares - 27,230 and 26,909		
Outstanding shares - 24,027 and 23,785	2	2
Additional paid-in capital	364,997	361,706
Accumulated deficit	(154,148)	(161,644)
Treasury stock:		
Shares at cost - 3,203 and 3,124	(82,531)	(80,230)
Total stockholders' equity	128,320	119,834
Total liabilities and stockholders' equity	$298,370	$316,710

See accompanying notes to unaudited consolidated financial statements.

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenue, net				
Direct	$33,592	$35,681	$104,854	$113,873
Fulfillment partner	319,399	265,745	921,889	792,751
Total net revenue	352,991	301,426	1,026,743	906,624
Cost of goods sold				
Direct(1)	29,385	30,777	91,955	99,768
Fulfillment partner	256,548	211,499	741,109	630,931
Total cost of goods sold	285,933	242,276	833,064	730,699
Gross profit	67,058	59,150	193,679	175,925
Operating expenses:				
Sales and marketing(1)	25,428	22,463	72,363	60,376
Technology(1)	22,202	17,259	63,211	53,339
General and administrative(1)	17,073	15,970	48,250	47,643
Restructuring	—	—	(360)	(471)
Total operating expenses	64,703	55,692	183,464	160,887
Operating income	2,355	3,458	10,215	15,038
Interest income	36	34	114	100
Interest expense	(11)	(33)	(30)	(121)
Other income (expense), net	(350)	165	633	360
Income before income taxes	2,030	3,624	10,932	15,377
Provision for income taxes	413	91	3,436	449
Net income	$1,617	$3,533	$7,496	$14,928
Net income per common share—basic:				
Net income attributable to common shares—basic	$0.07	$0.15	$0.31	$0.63
Weighted average common shares outstanding—basic	24,027	23,766	23,988	23,692
Net income per common share—diluted:				
Net income attributable to common shares—diluted	$0.07	$0.14	$0.31	$0.61
Weighted average common shares outstanding—diluted	24,283	24,446	24,290	24,297
Comprehensive income	$1,617	$3,533	$7,496	$14,928

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

Cost of goods sold — direct	$45	$37	$130	$117
Sales and marketing	77	44	255	123
Technology	183	33	550	235
General and administrative	693	695	2,014	1,902
Total	$998	$809	$2,949	$2,377

See accompanying notes to unaudited consolidated financial statements.

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Overstock.com, Inc.
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)
(in thousands)

	Common stock		Additional Paid-in	Accumulated	Treasury stock		
	Shares	Amount	Capital	Deficit	Shares	Amount	Total
Balances at December 31, 2013	26,909	$2	$361,706	$(161,644)	3,124	$(80,230)	$119,834
Net income	—	—	—	7,496	—	—	7,496
Stock-based compensation to employees and directors	—	—	2,949	—	—	—	2,949
Common stock issued upon vesting of restricted stock	301	—	—	—	—	—	—
Exercise of stock options	20	—	342	—	—	—	342
Purchase of treasury stock	—	—	—	—	79	(2,301)	(2,301)
Balances at September 30, 2014	27,230	$2	$364,997	$(154,148)	3,203	$(82,531)	$128,320

See accompanying notes to unaudited consolidated financial statements.

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Overstock.com, Inc.
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Nine months ended September 30,		Twelve months ended September 30,	
	2014	2013	2014	2013
Cash flows from operating activities:				
Net income	$7,496	$14,928	$78,020	$23,715
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization	12,806	10,833	16,495	14,907
Realized gain from sale of marketable securities	(11)	(28)	(16)	(29)
Stock-based compensation to employees and directors	2,949	2,377	3,823	3,280
Deferred income taxes	2,909	—	(66,685)	—
Amortization of debt discount and deferred loan costs	—	14	4	32
Loss on investment in precious metals	752	475	1,734	475
Loss on investment in cryptocurrency	50	—	50	—
Restructuring (reversals)	(360)	(471)	(360)	(448)
Changes in operating assets and liabilities:				
Restricted cash	—	125	75	280
Accounts receivable, net	1,106	4,601	(269)	(652)
Inventories, net	1,760	3,731	(2,550)	(1,343)
Prepaid inventories, net	81	(14)	203	(258)
Prepaids and other current assets	(3,484)	(2,995)	(1,025)	(1,387)
Other long-term assets, net	(7)	(445)	440	448
Accounts payable	(27,512)	(7,779)	8,447	11,277
Accrued liabilities	(3,164)	(2,308)	17,103	4,711
Deferred revenue	3,330	(8,553)	10,793	1,044
Other long-term liabilities	803	(707)	3,083	(786)
Net cash (used in) provided by operating activities	(496)	13,784	69,365	55,266
Cash flows from investing activities:				
Purchases of marketable securities	(19)	(111)	(40)	(124)
Purchases of intangible assets	(54)	(13)	(54)	(13)
Sales of marketable securities	77	291	78	291
Investment in precious metals	—	(5,980)	(2,100)	(7,377)
Investment in cryptocurrency	(396)	—	(396)	—
Expenditures for fixed assets, including internal-use software and website development	(32,544)	(13,970)	(36,641)	(15,896)
Net cash used in investing activities	(32,936)	(19,783)	(39,153)	(23,119)
Cash flows from financing activities:				
Payments on capital lease obligations	(325)	(2,563)	(325)	(2,563)
Payments on line of credit	—	—	—	(17,000)
Paydown on direct financing arrangement	(209)	(192)	(275)	(253)
Change in restricted cash	—	—	125	—
Proceeds from exercise of stock options	342	1,458	444	1,458
Purchase of treasury stock	(2,301)	(1,389)	(2,303)	(1,396)
Net cash used in financing activities	(2,493)	(2,686)	(2,334)	(19,754)
Net (decrease) increase in cash and cash equivalents	(35,925)	(8,685)	27,878	12,393
Cash and cash equivalents, beginning of period	148,665	93,547	84,862	72,469

Cash and cash equivalents, end of period	$112,740	$84,862	$112,740	$84,862

Continued on the following page

Overstock.com, Inc.
Consolidated Statements of Cash Flows (Unaudited)
(Continued)
(in thousands)

	Nine months ended September 30,		Twelve months ended September 30,	
	2014	2013	2014	2013
Supplemental disclosures of cash flow information:				
Cash paid during the period:				
Interest paid	$37	$56	$52	$202
Taxes paid	36	598	267	758
Non-cash investing and financing activities:				
Fixed assets, including internal-use software and website development, costs financed through accounts payable and accrued liabilities	$505	$89	$635	$10
Equipment acquired under capital lease obligations	325	2,563	325	2,563

See accompanying notes to unaudited consolidated financial statements.

Overstock.com, Inc.
Notes to Unaudited Consolidated Financial Statements

1. BASIS OF PRESENTATION

As used herein, “Overstock,” “Overstock.com,” “O.co,” “we,” “our” and similar terms include Overstock.com, Inc. and its subsidiaries, unless the context indicates otherwise. We have prepared the accompanying unaudited consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations and our audited annual consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2013. The accompanying unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, which are, in our opinion, necessary for a fair presentation of results for the interim periods presented. Preparing financial statements requires us to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on our best knowledge of current events and actions that we may undertake in the future, actual results may be different from the estimates. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

The Consolidated Balance Sheet at December 31, 2013 includes an immaterial revision to current and deferred tax assets and our provision for income taxes in 2013. The effect of the revision was to reduce current and long-term deferred tax assets by $121,000 and $2.9 million, respectively, with an offsetting increase of $3.0 million to our provision for income taxes in 2013. We evaluated these changes in accordance with Staff Accounting Bulletin No. 99, Materiality ("SAB 99"), and Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"), and determined that the revisions were not material to the prior period.

2. ACCOUNTING POLICIES

Principles of consolidation

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

Use of estimates

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

Cash equivalents

We classify all highly liquid instruments, including money market funds with a remaining maturity of three months or less at the time of purchase, as cash equivalents. Cash equivalents were $80.1 million and $58.1 million at

September 30, 2014 and December 31, 2013, respectively.

Restricted cash

We consider cash that is legally restricted and cash that is held as a compensating balance for letter of credit arrangements as restricted cash. Restricted cash was $1.6 million at September 30, 2014 and December 31, 2013.

Fair value of financial instruments

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Our financial instruments, including cash, cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities are carried at cost, which approximates their fair value because of the short-term maturity of these instruments.

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

- Level 1—Quoted prices for identical instruments in active markets;
- Level 2—Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3—Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

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

The fair value of these financial instruments was determined using the following levels of inputs as of September 30, 2014 (in thousands):

	Fair Value Measurements at September 30, 2014:			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash equivalents - Money market mutual funds	$80,089	$80,089	$—	$—
Trading securities held in a “rabbi trust” (1)	85	85	—	—
Total assets	$80,174	$80,174	$—	$—
Liabilities:				
Deferred compensation accrual “rabbi trust” (2)	$88	$88	$—	$—
Total liabilities	$88	$88	$—	$—

The fair value of these financial instruments was determined using the following levels of inputs as of December 31, 2013 (in thousands):

	Fair Value Measurements at December 31, 2013:			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash equivalents - Money market mutual funds	$58,081	$58,081	$—	$—
Trading securities held in a “rabbi trust” (1)	138	138	—	—
Total assets	$58,219	$58,219	$—	$—
Liabilities:				
Deferred compensation accrual “rabbi trust” (2)	$212	$212	$—	$—
Total liabilities	$212	$212	$—	$—

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

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

Restricted investments

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We have a Non Qualified Deferred Compensation Plan (the "NQDC Plan") for senior management. Deferred compensation amounts are invested in mutual funds held in a "rabbi trust" and are restricted for payment to the participants of the NQDC Plan. We account for our investments held in the trust in accordance with Accounting Standards Codification ("ASC") No. 320 "Investments — Debt and Equity Securities." The investments held in the trust are classified as trading securities. The fair value of the investments held in the trust totaled $85,000 at September 30, 2014 and are included in Other current and Other long-term assets in the consolidated balance sheets. Our gains and losses on these investments were immaterial for the three and nine months ended September 30, 2014 and 2013.

Accounts receivable

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

Allowance for doubtful accounts

From time to time, we grant credit to some of our business customers on normal credit terms (typically 30 days). We perform credit evaluations of our business customers' financial condition and payment history and maintain an allowance for doubtful accounts receivable based upon our historical collection experience and expected collectability of accounts receivable. The allowance for doubtful accounts receivable was $367,000 and $152,000 at September 30, 2014 and December 31, 2013, respectively.

Concentration of credit risk

Cash equivalents include short-term, highly liquid instruments with maturities at date of purchase of three months or less. At September 30, 2014 and December 31, 2013, two banks held the majority of our cash and cash equivalents. We do not believe that, as a result of this concentration, we are subject to any unusual financial risk beyond the normal risk associated with commercial banking relationships.

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

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

Valuation of inventories

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

Prepaid inventories, net

Prepaid inventories, net represent inventories paid for in advance of receipt. Prepaid inventories, net were $1.7 million and $1.8 million at September 30, 2014 and December 31, 2013, respectively.

Prepaids and other current assets

Prepaids and other current assets represent expenses paid prior to receipt of the related goods or services, including advertising, license fees, maintenance, packaging, insurance, and other miscellaneous costs. Total prepaids and other assets were $14.1 million at September 30, 2014 and $10.3 million at December 31, 2013.

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Fixed assets

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

	Life (years)
Computer software	2-4
Computer hardware	3-4
Furniture and equipment	3-5

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Cost of goods sold - direct	$61	$87	$217	$292
Technology	4,356	2,937	11,752	9,595
General and administrative	284	283	837	946
Total depreciation and amortization, including internal-use software and website development	$4,701	$3,307	$12,806	$10,833

In September 2014, in connection with the construction of our new corporate headquarters, we closed on the purchase of land for approximately $11.0 million which is included in Fixed assets, net at September 30, 2014.

Internal-use software and website development

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

During the three months ended September 30, 2014 and 2013, we capitalized $3.6 million and $3.3 million, respectively, of costs associated with internal-use software and website development, both developed internally and acquired externally. Amortization of costs associated with internal-use software and website development was $2.7 million and $1.8 million for those respective periods. During the nine months ended September 30, 2014 and 2013, we capitalized $10.7 million and $8.1 million, respectively, of such costs and had amortization of $7.6 million and $5.9 million for those respective periods.

Leases

We account for lease agreements as either operating or capital leases depending on certain defined criteria. In certain of our lease agreements, we receive rent holidays and other incentives. We recognize lease costs on a straight-line basis without regard to deferred payment terms, such as rent holidays, that defer the commencement date of required payments. Additionally, tenant improvement allowances are amortized as a reduction in rent expense over the term of the lease. Leasehold improvements are capitalized at cost and amortized over the lesser of their expected useful life or

the life of the lease, without assuming renewal features, if any, are exercised.

Treasury stock

We account for treasury stock under the cost method and include treasury stock as a component of stockholders' equity.

Precious Metals

Our investments in precious metals were $8.9 million at September 30, 2014 and $9.7 million at December 31, 2013. Our precious metals were comprised of $4.0 million in gold and $4.9 million in silver at September 30, 2014, and $4.0 million in gold and $5.7 million in silver at December 31, 2013. We store our precious metals at an off-site facility. Because these assets consist of actual precious metals, rather than financial instruments, we account for them as a cost method investment initially recorded at cost (including transaction fees) and then adjusted to the lower of cost of market based on an average unit cost. On an interim basis, we recognize decreases in the value of these assets caused by market declines. Subsequent increases in the value of these assets through market price recoveries during the same fiscal year are recognized in the later interim period, but may not exceed the total previously recognized decreases in value during the same year. Gains or losses resulting from changes in the value of our precious metal assets are recorded in Other income (expense), net in our Consolidated Statements of Income and Comprehensive Income. There were $752,000 of losses on investments in precious metals for the three and nine months ended September 30, 2014. Losses on investments in precious metals were $93,000 and $475,000 for the three and nine months ended September 30, 2013, respectively.

Goodwill

Goodwill represents the excess of the purchase price paid over the fair value of the tangible net assets acquired in business combinations.

Goodwill is not amortized but is tested for impairment at least annually. When evaluating whether goodwill is impaired, we make a qualitative assessment to determine if it is more likely than not that its fair value is less than its carrying amount. If the qualitative assessment determines that it is more likely than not that its fair value is less than its carrying amount, we compare the fair value of the reporting unit to which the goodwill is assigned to its carrying amount. If the carrying amount exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss, if any, is calculated by comparing the implied fair value of the goodwill to its carrying amount. In calculating the implied fair value of goodwill, the fair value of the reporting unit is allocated to the other assets and liabilities within the reporting unit based on estimated fair value. The excess of the fair value of a reporting unit over the amount allocated to its other assets and liabilities is the implied fair value of goodwill. An impairment loss is recognized when the carrying amount of goodwill exceeds its implied fair value.

In accordance with this guidance, we test for impairment of goodwill in the fourth quarter or when we deem that a triggering event has occurred. Goodwill totaled $2.8 million at September 30, 2014 and December 31, 2013, respectively. There were no impairments to goodwill recorded during the nine months ended September 30, 2014 or the year ended December 31, 2013.

Cryptocurrency holdings

We hold cryptocurrency denominated assets such as bitcoin. We currently consider these holdings to be investments and include them with other long-term assets in our Consolidated Balance Sheets. Cryptocurrency denominated assets were $346,000 and zero at September 30, 2014 and December 31, 2013, respectively, and are recorded at the lower of cost or market based on an average unit cost. We recognize decreases in the value of these assets caused by market declines. Subsequently, to the extent that fair value increases, we recognize price recoveries but not greater than the original cost. Gains or losses resulting from changes in the value of our cryptocurrency assets are recorded in Other income (expense), net in our Consolidated Statements of Income and Comprehensive Income. Losses on cryptocurrency holdings were $50,000 during the three and nine months ended September 30, 2014. There were no losses on cryptocurrency holdings for the three and nine months ended September 30, 2013.

Other long-term assets

Other long-term assets consist primarily of long-term prepaid expenses.

Impairment of long-lived assets

We review property and equipment and other long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability is measured by comparison of the assets' carrying amount to future undiscounted net cash flows the asset group is expected to generate. Cash flow forecasts are based on trends of historical performance and management's estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions. If such asset group is considered to be impaired,

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the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair values. There were no impairments to long-lived assets recorded during the nine months ended September 30, 2014 or the year ended December 31, 2013.

Revenue recognition

We derive our revenue primarily from direct revenue and fulfillment partner revenue from merchandise sales. We also earn revenue from advertising on our shopping and other pages. We have organized our operations into two principal segments based on the primary source of revenue: direct revenue and fulfillment partner revenue (see Note 8—Business Segments).

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

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

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

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

Direct revenue

Direct revenue is derived from merchandise sales to individual consumers and businesses that are fulfilled from our warehouses or warehouses we control through third party logistic agreements. Direct revenue comes from merchandise sales that occur primarily through our Website, but may also occur through offline and other channels.

Fulfillment partner revenue

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

merchandise sales that occur primarily through our Website, but may also occur through offline and other channels.

Club O loyalty program

We have a customer loyalty program called Club O for which we sell annual memberships ("standard Club O"). We also recently introduced an introductory customer loyalty program called Club O Lite for customers who sign up to receive promotional emails. For standard Club O memberships, we record membership fees as deferred revenue and we recognize revenue ratably over the membership period. Both the standard Club O and Club O Lite loyalty programs allow members to earn reward dollars for qualifying purchases made on our Website. We also have a co-branded credit card program (see “Co-

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branded credit card revenue" below for more information). Co-branded cardholders are also standard Club O members and earn additional reward dollars for purchases made on our Website, and from other merchants.

Club O Reward dollars earned may be redeemed on future purchases made through our Website. Standard Club O membership reward dollars expire 90 days after the customer's Club O membership expires. Club O Lite reward dollars expire 90 days after they are earned if no additional qualifying purchases are made during that period.

We account for these transactions as multiple element arrangements and allocate revenue to the elements using their relative fair values. We include the value of reward dollars earned in deferred revenue and we record it as a reduction of revenue at the time the reward dollars are earned.

We recognize revenue for Club O reward dollars when customers redeem their reward dollars as part of a purchase at our Website. We recognize other income when Club O Reward dollars expire or the likelihood of reward dollars being redeemed by a customer is remote ("reward dollar breakage"). Reward dollar breakage is currently recognized when the reward dollars expire. Because we recently introduced Club O Lite, and enrolled a significant number of Club O Lite members, reward dollar breakage may increase as compared to prior periods.

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

Co-branded credit card program

We have a co-branded credit card agreement with a commercial bank for the issuance of credit cards bearing the Overstock.com brand, under which the bank pays us fees for new accounts and for customer usage of the cards. The agreement also provides for a customer loyalty program offering reward points that customers accrue from card usage and can use to make purchases on our Website (see "Club O loyalty program" above for more information). New account fees are recognized as revenue on a straight-line basis over the remaining life of the credit card relationship which runs through April 2015. Credit card usage fees are recognized as revenues as actual credit card usage occurs. Revenues from new account and credit card usage fees were less than 1% of total net revenues for all periods presented.

Deferred revenue

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

We periodically enter into agreements with other parties to jointly market ancillary products or services on our website. As a result of those agreements, we will occasionally receive payments in advance of performing our obligations under those agreements. Such payments received before we perform our obligations are recognized over our service period.

Sales returns allowance

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

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

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

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

The allowance for returns was $9.2 million and $13.2 million at September 30, 2014 and December 31, 2013 respectively. The decrease in allowance for returns at September 30, 2014 compared to December 31, 2013 is primarily due to decreased revenues mostly due to seasonality.

Credit card chargeback allowance

Revenue is recorded net of credit card chargebacks. We maintain an allowance for credit card chargebacks based on current period revenues and historical chargeback experience. The allowance for chargebacks was $86,000 and $94,000 at September 30, 2014 and December 31, 2013, respectively.

Cost of goods sold

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

	Three months ended September 30,						Nine months ended September 30,					
	2014			2013			2014			2013		
Total revenue, net	$352,991	100	%	$301,426	100	%	$1,026,743	100	%	$906,624	100	%
Cost of goods sold												
Product costs and other cost of goods sold	270,219	77	%	228,963	76	%	786,981	77	%	690,563	76	%
Fulfillment and related costs	15,714	4	%	13,313	4	%	46,083	4	%	40,136	4	%
Total cost of goods sold	285,933	81	%	242,276	80	%	833,064	81	%	730,699	81	%
Gross profit	$67,058	19	%	$59,150	20	%	$193,679	19	%	$175,925	19	%

Advertising expense

We expense the costs of producing advertisements the first time the advertising takes place and expense the cost of communicating advertising in the period during which the advertising space or airtime is used. Internet advertising expenses are recognized as incurred based on the terms of the individual agreements, which are generally: 1) a commission for traffic driven to the Website that generates a sale or 2) a referral fee based on the number of clicks on keywords or links to our Website generated during a given period. Advertising expense is included in sales and marketing expenses and totaled $23.1 million and $20.2 million during the three months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014 and 2013, advertising expenses totaled $64.8 million and $53.5 million, respectively. Prepaid advertising (included in Prepaids and other current assets in the accompanying Consolidated Balance Sheets) was $2.0 million and $1.4 million at September 30, 2014 and December 31, 2013, respectively.

Stock-based compensation

We measure compensation expense for all outstanding unvested share-based awards at fair value on the date of grant and recognize compensation expense over the service period for awards expected to vest at the greater of a straight line basis or on an accelerated schedule when vesting of restricted stock awards exceeds a straight line basis. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from estimates, such amounts will be recorded as an adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, and historical experience. Actual results may differ substantially from these estimates (see Note 7—Stock-Based Awards).

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Loss contingencies

In the normal course of business, we are involved in legal proceedings and other potential loss contingencies. We accrue a liability for such matters when it is probable that a loss has been incurred and the amount can be reasonably estimated. When only a range of probable loss can be estimated, the most probable amount in the range is accrued. If no amount within this range is a better estimate than any other amount within the range, the minimum amount in the range is accrued. We expense legal fees as incurred (see Note 5—Commitments and Contingencies).

Restructuring

Restructuring expenses are primarily comprised of lease termination costs. ASC Topic 420, Accounting for Costs Associated with Exit or Disposal Activities, requires that when an entity ceases using a property that is leased under an operating lease before the end of the contractual term, the termination costs should be recognized and measured at fair value when the entity ceases using the facility. Key assumptions in determining the restructuring expenses include the terms that may be negotiated to exit certain contractual obligations (see Note 3—Restructuring Expense).

Income taxes

Our income tax provision for interim periods is determined using an estimate of our annual effective tax rate adjusted for discrete items, if any, for relevant interim periods. We update our estimate of the annual effective tax rate each quarter and make cumulative adjustments if our estimated annual effective tax rate changes.

Our quarterly tax provision and our quarterly estimate of our annual effective tax rate are subject to significant variations due to several factors including variability in predicting our pre-tax and taxable income and the mix of jurisdictions to which those items relate, relative changes of expenses or losses for which tax benefits are not recognized, how we do business, and changes in law, regulations, and administrative practices. Our effective tax rate can be volatile based on the amount of pre-tax income. For example, the impact of discrete items on our effective tax rate is greater when pre-tax income is lower. The tax provision does not include a benefit for the federal research credit, which expired at the end of 2013. If retroactively reinstated, the credit will be a discrete tax benefit in the period enacted.

We have not provided for U.S. income tax on certain foreign earnings because we intend to indefinitely reinvest these earnings outside the U.S. We have begun expansion of operations outside of the U.S. and have plans for additional expansion for which we have incurred and will continue to incur capital requirements. We have considered ongoing capital requirements of the parent company in the U.S.

We have tax deductions from stock-based compensation that exceed the stock-based compensation recorded for such instruments. To the extent such excess tax benefits are ultimately realized, they will increase shareholders' equity. We utilize the "with-and-without" approach in determining if and when such excess tax benefits are realized. Under this approach, excess tax benefits related to stock-based compensation are the last tax benefits to be realized.

Earnings per share

Basic earnings per share is computed by dividing net income attributable to common shares by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income attributable to common shares for the period by the weighted average number of common and potential common shares outstanding during the period. Potential common shares, comprising incremental common shares issuable upon the exercise of stock options and restricted stock awards are included in the calculation of diluted earnings per common share to the extent such shares are dilutive.

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The following table sets forth the computation of basic and diluted net income per common share for the periods indicated (in thousands, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Net income attributable to common shares	$1,617	$3,533	$7,496	$14,928
Net income per common share—basic:				
Net income attributable to common shares—basic	0.07	0.15	0.31	0.63
Weighted average common shares outstanding—basic	24,027	23,766	23,988	23,692
Effect of dilutive securities:				
Stock options and restricted stock awards	256	680	302	605
Weighted average common shares outstanding—diluted	24,283	24,446	24,290	24,297
Net income attributable to common shares—diluted	$0.07	$0.14	$0.31	$0.61

The following shares were excluded from the calculation of diluted shares outstanding as their effect would have been anti-dilutive (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Stock options and restricted stock units	463	6	386	38

Recently issued accounting standards

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard becomes effective for us on January 1, 2017. Early adoption is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

3. RESTRUCTURING EXPENSE

During the fourth quarter of 2006, we began a facilities consolidation and restructuring program designed to reduce the overall expense structure in an effort to improve future operating performance. The facilities consolidation and restructuring program was substantially completed by the end of the second quarter of 2007.

Restructuring liabilities along with charges (credits) to expense and payments associated with the facilities consolidation and restructuring program are as follows (in thousands):

	Balance at 12/31/2013	Accretion Expense	Net Cash Payments	Adjustments	Balance at 9/30/2014
Lease and contract termination costs	$445	$7	$(92)	$(360)	$—

We reversed $0 and $360,000, respectively, of lease termination costs during the three and nine months ended September 30, 2014. The reversal was a result of our reoccupation of formerly restructured facility space. At September 30, 2014 our restructuring liability was $0.

There were $0 and $471,000, respectively, of lease termination costs during the three and nine months ended September 30, 2013. The reversal was a result of our reoccupation of formerly restructured facility space.

4. BORROWINGS

U.S. Bank Financing Agreements

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On December 26, 2012, we entered into a $3.0 million cash-collateralized line of credit agreement (the "Credit Agreement") with U.S. Bank National Association ("U.S. Bank") for the issuance of letters of credit. Advances under the Credit Agreement bear interest at one-month LIBOR plus 1.0%. The Credit Agreement matures on December 31, 2014. Amounts outstanding under the Credit Agreement were $0 at September 30, 2014 and December 31, 2013.

At September 30, 2014 and December 31, 2013, letters of credit totaling $1.6 million were issued on our behalf collateralized by compensating cash balances held at U.S. Bank, which are included in Restricted cash in the accompanying consolidated balance sheets.

U.S. Bank Commercial Purchasing Card Agreement

We have a commercial purchasing card (the "Purchasing Card") agreement with U.S. Bank. We use the Purchasing Card for business purpose purchasing and must pay it in full each month. At September 30, 2014, $471,000 was outstanding and $4.5 million was available under the Purchasing Card. At December 31, 2013, $517,000 was outstanding and $4.5 million was available under the Purchasing Card.

Capital leases

In May 2014 and March 2013, we entered into capital lease arrangements of computer equipment for $325,000 and $2.6 million, respectively. These arrangements will expire in 2017. In order to obtain discounted pricing, we prepaid the entire $325,000 and $2.6 million shortly after entering into the respective agreements. As such, we have no future payment obligations under capital leases at September 30, 2014 and December 31, 2013.

Fixed assets included assets under capital leases of $4.6 million and $4.2 million and accumulated depreciation related to assets under capital leases of $2.6 million and $2.1 million, respectively, at September 30, 2014 and December 31, 2013. Depreciation expense of assets recorded under capital leases was $188,000 and $161,000, for the three months ended September 30, 2014 and 2013, respectively and $518,000 and $268,000, for the nine months ended September 30, 2014 and 2013, respectively.

5. COMMITMENTS AND CONTINGENCIES

Summary of future minimum lease payments for all operating leases

Minimum future payments under all operating leases as of September 30, 2014, are as follows (in thousands):

Payments due by period	
2014 (remainder)	$2,677
2015	10,714
2016	8,483
2017	4,224
2018	3,826
Thereafter	32,437
	$62,361

Rental expense for operating leases totaled $2.9 million and $2.6 million for the three months ended September 30, 2014 and 2013, respectively and $8.7 million and $7.2 million for the nine months ended September 30, 2014 and 2013, respectively. There is no estimated sublease income expected over the next five years.

On March 6, 2014 we entered into amendments to extend the leases on our corporate headquarters and a data center space from their previous expiration of June 30, 2016 to January 31, 2017. The minimum future payments due under these amended operating leases are included in the summary of future minimum lease payments for all operating leases in the table above.

Naming rights

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During 2011, we entered into a six-year agreement with the Oakland-Alameda County Coliseum Authority ("OACCA") for the right to name the Oakland Alameda County Coliseum. Amounts shown below represent annual payments due OACCA for the naming rights. We have the right to terminate this agreement at our sole option, subject to payment of a termination fee.

Minimum future payments under naming rights agreement as of September 30, 2014, are as follows (in thousands):

Payments due by period:	
2014 (remainder)	$1,311
2015	1,351
2016	1,391
Thereafter	—
	$4,053

Technology

From time to time we enter into non-cancellable, long-term contractual agreements for technology services. Minimum future payments under these agreements as of September 30, 2014, are as follows (in thousands):

Payments due by period:	
2014 (remainder)	$—
2015	2,901
2016	1,683
Thereafter	—
	$4,584

Legal Proceedings

From time to time, we are involved in litigation concerning consumer protection, employment, intellectual property and other commercial matters related to the conduct and operation of our business and the sale of products on our Website. In connection with such litigation, we may be subject to significant damages. In some instances other parties may have contractual indemnification obligations to us. However, such contractual obligations may prove unenforceable or non-collectible, and in the event we cannot enforce or collect on indemnification obligations, we may bear the full responsibility for damages, fees and costs resulting from such litigation. We may also be subject to penalties and equitable remedies that could force us to alter important business practices. Such litigation could be costly and time consuming and could divert or distract our management and key personnel from our business operations. Due to the uncertainty of litigation and depending on the amount and the timing, an unfavorable resolution of some or all of these matters could materially affect our business, results of operations, financial position, or cash flows.

On February 2, 2007, along with five shareholder plaintiffs, we filed a lawsuit in the Superior Court of California, County of San Francisco against Morgan Stanley & Co. Incorporated, Goldman Sachs & Co., Bear Stearns Companies, Inc., Bank of America Securities LLC, Bank of New York, Citigroup Inc., Credit Suisse (USA) Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., and UBS Financial Services, Inc., and later amended the complaint to add Lehman Brothers Holdings Inc. as a defendant. The suit alleged that the defendants, who controlled over 80% of the prime brokerage market, participated in an illegal stock market manipulation scheme and that the defendants had no intention of covering short sell orders with borrowed stock, as they are required to do, causing what are referred to as “fails to deliver” and that the defendants’ actions caused and continued to cause dramatic declines in the share price of our stock and that the amount of “fails to deliver” often exceeded our entire supply of outstanding shares. The suit accused the defendants of violations of California securities laws and common law and violations of California’s Unfair Business Practices Act. After it filed for bankruptcy on September 2008, we elected not to pursue our claims against Lehman Brothers Holdings. On July 23, 2009, the court

sustained defendants' demurrer to our amended causes of action for conversion and trespass to chattels. On December 15, 2010, we and the other plaintiffs in the case entered into a settlement agreement with certain of the defendants requiring these defendants to pay in the aggregate $4.5 million to plaintiffs. Other terms of settlement are confidential. At that time, remaining defendants in the suit were Goldman Sachs Group, Inc., Goldman Sachs & Co., Goldman Sachs Execution & Clearing L.P., ("Goldman Defendants") Merrill Lynch, Pierce, Fenner & Smith, Inc., Merrill Lynch Professional Clearing Corporation ("Merrill Lynch

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Defendants), and Bank of America Securities LLC. On December 15, 2010, we filed a motion to amend our complaint against the Goldman and Merrill Lynch Defendants to add a cause of action based on the New Jersey Racketeer Influenced and Corrupt Organization (RICO) Act. Defendants challenged the RICO claim by demurrer and eventually the court sustained the demurrer. We thereafter entered a settlement agreement with Bank of America Securities LLC, the terms of which are confidential, and have dismissed the action as to that defendant. On August 19, 2011, the remaining defendants filed a motion for summary judgment. On January 10, 2012, the court granted the motion for summary judgment as to all remaining defendants and the judgment has been entered. We have appealed that decision and each side has appealed the trial court's decisions regarding sealing of certain records in the case. The defendants applied to the court for reimbursement from us of their allowable court costs in the collective amount of $2.4 million. We challenged the application, and the court reduced the amount to $689,471, which will be payable only if we do not succeed on our appeal of the summary judgment. The Court of Appeal heard oral argument of all appeals on August 15, 2014. The Court of Appeal has not yet rendered a decision. The nature of the loss contingencies relating to any court costs ordered against us are described above.

On September 23, 2009, SpeedTrack, Inc. sued us along with 27 other defendants in the United States District Court in the Northern District of California. We are alleged to have infringed a patent covering search and categorization software. We believe that certain third party vendors of products and services sold to us are contractually obligated to indemnify us in this action. On November 11, 2009, the parties stipulated to stay all proceedings in the case until resolution of a reexamination of the patent in question, and also until a previously filed infringement action against Wal-Mart Stores, Inc. and other retailers resulted either in judgment or dismissal. Subsequently, the parties agreed to extend the time for defendants to answer until 21 days following a court order to lift the stay to which the parties stipulated. The United States Patent and Trademark Office resolved the reexamination of the patent in question in favor of SpeedTrack, Inc. The case remains stayed, pending the outcome and appeal of the infringement action against Wal-Mart Stores, Inc. and other retailers. On February 22, 2012, the court in the Wal-Mart Stores case granted Wal-Mart Stores' motion for summary judgment of non-infringement. The court also granted Speedtrack's motion for summary judgment on patent validity. Speedtrack appealed, and the ruling was upheld. It is not known whether the summary judgments granted in the Wal-Mart Stores case will have an effect on the Speedtrack case in which we are named as one of the defendants. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However no estimate of the loss or range of loss can be made. We intend to vigorously defend this action and pursue our indemnification rights with our vendors.

On September 29, 2010, a trustee in bankruptcy filed against us an adversary proceeding in the matter of In re: Petters Company, Inc., a case filed in United States Bankruptcy Court, in the District of Minnesota. The complaint alleges principal causes of action against us under various Bankruptcy Code sections and the Minnesota Fraudulent Transfer Act, to recover damages for alleged transfers of property from the Petters Company occurring prior to the filing of the case initially as a civil receivership in October 2008. The trustee's complaint alleges such transfers occurred in at least one note transaction whereby we transferred at least $2.3 million and received in return transfers totaling at least $2.5 million. The case is in its discovery stages. We filed a motion to dismiss on statute of limitations and other grounds. The court consolidated the issues in our motion with issues raised by motion in similar trustee-filed cases. The court issued legal rulings on these consolidated legal issues, and has allowed portions of the case to proceed to the discovery stage. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made. We intend to vigorously defend this action.

On November 17, 2010, we were sued in the Superior Court of California, County of Alameda, by District Attorneys for the California Counties of Alameda, Marin, Monterey, Napa, Santa Clara, Shasta and Sonoma County, and the County of Santa Cruz later joined the suit. These district attorneys sought damages and an injunction under claims for violations of California consumer protection laws, alleging we made untrue or misleading statements concerning our pricing, price reductions, sources of products and shipping charges. The complaint asked for damages in the amount of not less than $15 million. We tried the case in September 2013 before the judge of the court and made final

arguments in December 2013. On January 3, 2014, the court issued a tentative ruling in favor of the District Attorneys, which became a final Statement of Decision on February 5, 2014. The decision provides for an injunction that prescribes disclosures necessary for certain types of price advertising and price reductions and imposes civil penalties of $3,500 per day for practices from March 2006 through September 2008, and $2,000 per day for September 2008 through September 2013, totaling $6.8 million. The court issued a Final Judgment February 19, 2014 reflecting the Court's Statement of Decision. We have stipulated to Plaintiff's reimbursement of costs in the amount of $111,500. We have appealed the decision and have secured a bond as required in the ruling in the amount of 150% of the penalty imposed in the matter until the ruling on the appeal. The appeal is in the briefing stages. No date has been set for oral argument. The nature of the loss contingencies relating to claims that have been asserted against us are described above. We intend to continue to vigorously pursue the appeal and defend this action.

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On September 11, 2011, Droplets, Inc. filed suit against us and eight other defendants in the United States District Court in the Eastern District of Texas for infringement of a patent covering strings of programming code downloaded from a server to a client computer. We have answered the complaint. The case is in its discovery stages and has been scheduled for trial in January 2015. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made. We intend to vigorously defend this action and pursue our indemnification rights with our vendors.

On March 1, 2012, H-W Technology, L.C. filed suit against us in the United States District Court in the Northern District of Texas for infringement of a patent entitled "Internet Protocol (IP) Phone with Search and Advertising Capability." On January 28, 2013, we filed a motion for summary judgment for invalidity on two claims of the patent. On September 23, 2013, the court granted the motion. H-W Technology appealed and on July 11, 2014, the appeals court upheld the lower court decision. H-W Technology did not contest the decision on further appeal. Our application to the court for court-ordered reimbursement of our legal fees and costs was denied. The case is now concluded.

On July 16, 2012, Digitech Image Technologies, LLC filed against us and 45 other defendants in the United States District Court for the Central District of California for infringement of a patent covering the imaging technology that facilitates prediction of color and location within digital cameras. The initial case was dismissed, but in September 2012, Digitech filed a new complaint on the same infringement claims. Subsequently, the court granted a motion for summary judgment on invalidity of the patent and entered judgment for us. Digitech appealed, and on July 11, 2014 the appeals court upheld the invalidity judgment. The case is now concluded.

On July 19, 2012, Data Carriers, LLC filed suit against us in the United States District Court for the District of Delaware for infringement of a patent covering the "autocomplete" features of our website. We answered the complaint, and on August 20, 2014, Data Carriers voluntarily dismissed its case with prejudice without any payment from us.

On February 11, 2013, RPost Holdings, Inc., RPost Communications Limited, and RMail Limited, filed suit against us in the United States District Court in Eastern District of Texas for infringement of patents covering products and services that verify the delivery and integrity of email messages. We tendered defense of the case to an indemnitor which accepted the defense. We answered the complaint. The case is in its early stages. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made. We intend to vigorously defend this action and pursue our indemnification rights with our vendors.

On August 16, 2013, Online News Link LLC, filed suit against us in the United States District Court in District of Delaware for infringement of patents covering data distribution systems that can make downloading data fast and efficient. We answered the complaint, and on September 24, 2014, Online News voluntarily dismissed its case with prejudice without any payment from us.

On January 31, 2014, Guardian Media Technologies LTD filed suit against us in the United States District Court in the Eastern District of Texas for infringement of patents covering parental control features in DVD players and televisions. The suit relates to two prior lawsuits with Guardian filed in 2008, and in 2013, which were previously dismissed. We have requested indemnification from pertinent vendors. The case is in its discovery stages. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made. We intend to vigorously defend this action and pursue any indemnification rights with our vendors.

On September 30, 2013, Altaf Nazerali filed suit against us in the Supreme Court of British Columbia for vicarious liability for defamation, liable and slander. The suit relates to alleged representations about Nazerali found on the website www.deepcapture.com. The suit alleges that the representations were made by our Chief Executive Officer,

Patrick Byrne, and two other employees. The case is in its early stages. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made.

In June of 2013, William French filed suit against us and 46 other defendants under seal in the Superior Court of the State of Delaware. The filing was unsealed on March 24, 2014. French brought the action on Delaware's behalf for violations of Delaware's unclaimed property laws and for recovery of the unredeemed gift card value allegedly attributable to Delaware residents. French's complaint alleges that we, and other defendants, knowingly refused to fulfill obligations under Delaware's Abandoned Property Law by failing to report and deliver unclaimed gift card funds to the State of Delaware, and knowingly made, used or caused to be made or used, false statements and records to conceal, avoid or decrease an obligation to pay or transmit money to Delaware in violation of the Delaware False Claims and Reporting Act. The complaint seeks an injunction,

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monetary damages (including treble damages) penalties, and attorneys' fees and costs. The case is in its early stages. The nature of the loss contingencies relating to claims that have been asserted against us are described above. However, no estimate of the loss or range of loss can be made.

We establish liabilities when a particular contingency is probable and estimable. At September 30, 2014, we have accrued $8.2 million in light of these probable and estimable liabilities. It is reasonably possible that the actual losses may exceed our accrued liabilities. We have other contingencies which are reasonably possible; however, the reasonably possible exposure to losses cannot currently be estimated.

6. INDEMNIFICATIONS AND GUARANTEES

During our normal course of business, we have made certain indemnities, commitments, and guarantees under which we may be required to make payments in relation to certain transactions. These indemnities include, but are not limited to, indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to our directors and officers to the maximum extent permitted under the laws of the State of Delaware. The duration of these indemnities, commitments, and guarantees varies, and in certain cases, is indefinite. In addition, the majority of these indemnities, commitments, and guarantees do not provide for any limitation of the maximum potential future payments we could be obligated to make. As such, we are unable to estimate with any reasonableness our potential exposure under these items. We have not recorded any liability for these indemnities, commitments, and guarantees in the accompanying consolidated balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is both probable and reasonably estimable.

7. STOCK-BASED AWARDS

We have equity incentive plans that provide for the grant to employees of stock-based awards, including stock options and restricted stock. During the three and nine months ended September 30, 2014, the Compensation Committee of the Board of Directors approved grants of zero and 232,985 restricted stock awards, respectively, to our officers, board members and employees. The restricted stock awards vest over three years at 33.3% at the end of the first year, 33.3% at the end of the second year and 33.3% at the end of the third year and are subject to the employee’s continuing service to us. At September 30, 2014, there were 582,075 unvested restricted stock awards that remained outstanding.

The cost of restricted stock awards is determined using the fair value of our common stock on the date of the grant, and compensation expense is either recognized on a straight line basis over the three-year vesting schedule or on an accelerated schedule when vesting of restricted stock awards exceeds a straight-line basis. The cumulative amount of compensation expense recognized at any point in time is at least equal to the portion of the grant date fair value of the award that is vested at that date. The weighted average grant date fair value of restricted stock awards granted during the three and nine months ended September 30, 2014 was $0 and $28.44, respectively.

Stock-based compensation expense related to restricted stock awards was $998,000 and $809,000 during the three months ended September 30, 2014 and 2013, respectively. During the nine months ended September 30, 2014 and 2013 stock-based compensation expense related to restricted stock awards was $2.9 million and $2.4 million, respectively.

The following table summarizes restricted stock award activity during the nine months ended September 30, 2014 (in thousands):

	Nine months ended September 30, 2014	
		Weighted Average

	Units	Grant Date Fair Value
Outstanding—beginning of year	704	$ 10.79
Granted at fair value	233	28.44
Vested	(301)	11.87
Forfeited	(54)	16.75
Outstanding—end of period	582	$ 16.71

8. BUSINESS SEGMENTS

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Segment information has been prepared in accordance with ASC Topic 280 Segment Reporting. Segments were determined based on how we manage the business. There were no inter-segment sales or transfers during the three and nine months ended September 30, 2014 and 2013. We evaluate the performance of our segments and allocate resources to them based primarily on gross profit. The table below summarizes information about reportable segments for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three months ended September 30,			Nine months ended September 30,		
	Direct	Fulfillment partner	Total	Direct	Fulfillment partner	Total
2014						
Revenue, net	$33,592	$319,399	$352,991	$104,854	$921,889	$1,026,743
Cost of goods sold	29,385	256,548	285,933	91,955	741,109	833,064
Gross profit	$4,207	$62,851	$67,058	$12,899	$180,780	$193,679
Operating expenses			64,703			183,464
Other income (expense), net			(325)			717
Provision for income taxes			413			3,436
Net income			$1,617			$7,496
2013						
Revenue, net	$35,681	$265,745	$301,426	$113,873	$792,751	$906,624
Cost of goods sold	30,777	211,499	242,276	99,768	630,931	730,699
Gross profit	$4,904	$54,246	$59,150	$14,105	$161,820	$175,925
Operating expenses			55,692			160,887
Other income (expense), net			166			339
Provision for income taxes			91			449
Net income			$3,533			$14,928

The direct segment includes revenues, direct costs, and cost allocations associated with sales fulfilled from our warehouses. Costs for this segment include product costs, freight, warehousing and fulfillment costs, credit card fees and customer service costs.

The fulfillment partner segment includes revenues, direct costs and cost allocations associated with sales fulfilled from warehouses maintained by our fulfillment partners. Costs for this segment include product costs, outbound freight and fulfillment costs, credit card fees and customer service costs.

Assets have not been allocated between the segments for our internal management purposes and, as such, they are not presented here.

For the three and nine months ended September 30, 2014 and 2013, substantially all sales revenues were attributable to customers in the United States. At September 30, 2014 and December 31, 2013, substantially all of our fixed assets were located in the United States.

9. SUBSEQUENT EVENTS

Construction Agreement

In October 2014 our subsidiary O.com Land, LLC entered into a Construction Agreement dated October 13, 2014 with Okland Construction Company Inc. for the construction of our future corporate headquarters on land O.Com

Land recently purchased in Salt Lake City.

Loan Agreement

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On October 24, 2014, in connection with our anticipated construction of our new corporate headquarters, we entered into a syndicated senior secured credit facility with U.S. Bank and other banks the terms of which are set forth in a Loan Agreement and related documentation dated October 24, 2014. The facility provides for an approximately 27-month construction loan of $45,760,000 (which is designed to subsequently convert into a term loan), and a three-year $10 million revolving loan facility. The construction loan is designed to convert into a term loan following completion of the construction of the headquarters and satisfaction of all conditions to the conversion. The term loan is to be for a period of approximately 6.75 years following conversion from the construction period. If the conditions to conversion are not satisfied in early 2017, both the construction loan and the revolver would become due immediately. All amounts due under the facility are secured by the headquarters and all related assets, as well as our inventory, accounts receivable and related assets.

The combined term of the construction loan and the term loan is expected to be approximately nine years with all amounts then outstanding due in full on October 1, 2023. The term loan will bear interest during both the construction and term periods at one-month LIBOR plus 2.00%. We will be required to pay interest only during the period of the construction loan. Upon conversion of the construction loan to the term loan, we will be required to make interest payments plus principal payments of approximately $1.1 million per year, with a balloon payment of $38 million due at maturity in 2023. As required by the loan agreement, we have obtained interest rate protection on the construction loan and the term loan by entering into approximately nine-year interest rate swap agreements with U.S. Bank and Compass Bank. The swaps are based on one-month LIBOR and effectively fix our interest cost on the construction and term loans at approximately 4.6% annually.

The $10 million in financing to be available under the revolving loan facility may be used for working capital, capital expenditures and other corporate purposes, but may not be used for the construction of the headquarters. The initial term of the revolving loan facility is 3 years which may be renewed with the consent of all lenders. The revolving loan facility bears interest at one-month LIBOR plus 2.00% and may be prepaid and re-borrowed without penalty during the term of the agreement.

No amounts will be available to us under the construction loan or revolving loan until we satisfy a number of conditions. We do not expect to satisfy the conditions prior to approximately September 1, 2015.

The loan agreement contains financial covenants requiring us to (a) maintain a fixed charge coverage ratio greater than 1.15 to 1.00 measured at each quarter-end on a trailing-twelve month basis, (b) maintain a leverage ratio less than 3.00 to 1.00 during the construction period and 2.50 to 1.00 thereafter as measured at each quarter-end on a trailing-twelve month basis, and (c) maintain a minimum liquidity of $50 million as measured at each quarter end.

The loan agreement and related agreements also impose numerous affirmative and negative covenants on the Company and its subsidiaries, as well as representations that must be true both initially and at every date on which the Company makes a request for an advance, whether under the construction loan or under the revolver. The covenants and the representations relate to both (i) the construction of the headquarters, and (ii) unrelated aspects of the Company’s business. If the Company is not in compliance or cannot make a required representation in the future, the lenders would not be required to fund additional amounts under the facility.
As of October 28, 2014, no amounts had been borrowed under the loan agreement.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference, as well as our other public documents and statements our officers and representatives may make from time to time, contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are therefore entitled to the protection of the safe harbor provisions of these laws. These forward-looking statements involve risks and uncertainties, and relate to future events or our future financial or operating performance. The forward-looking statements include all statements other than statements of historical fact, including, without limitation, all statements regarding:

- the anticipated benefits and risks of our business and plans;
- our beliefs regarding our ability to attract and retain customers in a cost-efficient manner;
- the anticipated effectiveness of our marketing;
- our future operating and financial results, including any projections of revenue, capital expenditures or other financial measures or amounts;
- our plans and expectations regarding our use of the real estate we recently purchased in the Salt Lake City Valley and our plans for the design and construction of an office campus on that real estate to serve as our corporate headquarters; our beliefs and expectations regarding the adequacy of our office and warehouse facilities and any additional or modified office or warehouse facilities and any transition from our current facilities to anticipated new facilities;
- our expectations regarding the benefits and risks of the Construction Agreement and related agreements we recently entered into in connection with our construction of an office campus to serve as our corporate headquarters and of the credit facility we recently entered into for the purpose of, among other things, financing a portion of the costs of that construction;
- our expectations regarding our ability to secure the additional financing that we will need to complete our corporate headquarters;
- our future capital requirements and our ability to satisfy our capital needs;
- our expectations regarding the adequacy of our liquidity;
- our ability to retire or refinance any debt we may have or incur in the future;
- our decision to accept bitcoins as payment for the goods and services we sell and our expectations regarding the advantages and risks of doing so, and our expectations that Coinbase.com and any other bitcoin transaction processing agents we utilize will perform in accordance with our expectations regardless of fluctuations in the value of bitcoin or other developments that may affect us or such processing agents;
- our decision to acquire and hold bitcoins and our expectations regarding the advantages and risks of doing so;
- the competition we currently face and will face in our business as the ecommerce business continues to evolve and to become more competitive, and as additional competitors, including competitors based in China or elsewhere, continue to increase their efforts in our primary markets;
- the effects of government regulation;
- our plans for international markets, our expectations for our international sales efforts and the anticipated results of our international operations;
- our plans and expectations regarding our recently-announced launch of our Supplier Oasis Fulfillment Services and our efforts to provide multi-channel fulfillment services;
- our plans and expectations regarding our recently-announced launch of our Farmers Market offerings;
- our plans and expectations regarding our recently announced launch of insurance product offerings and consumer finance offerings;
- our plans for further changes to our business;

- our beliefs regarding current or future litigation or regulatory actions;
- our beliefs regarding the costs and benefits of our “spend and defend” policy under which we generally refuse to settle abusive patent suits brought against us;
- our beliefs and expectations regarding existing and future tax laws and related laws and the application of those laws to our business;
- our beliefs regarding the adequacy of our insurance coverage;

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- our beliefs regarding the adequacy and anticipated functionality of our infrastructure, including our backup facilities and beliefs regarding the adequacy of our disaster planning and our ability to recover from a disaster or other interruption of our ability to operate our website at its highest level of functionality;
- our beliefs regarding our cybersecurity efforts and measures and the costs we will incur in our ongoing efforts to avoid interruptions to our product offerings and other business processes from cyber attacks;
- our belief that we can meet our published product shipping standards even during periods of relatively high sales activity;
- our belief that we can maintain or improve upon customer service levels that we and our customers consider acceptable;
- our beliefs regarding the adequacy of our order processing systems and our fulfillment and distribution capabilities;
- our beliefs regarding the adequacy of our order processing systems and our fulfillment and distribution capabilities;
- our expectations regarding the costs and benefits of our other businesses including our new and used car listing service, our Worldstock Fair Trade offerings, our Main Street Revolution offerings, our consignment services, our ecommerce marketplace channel offerings, and other future businesses and the anticipated functionality and results of operations of them;
- our expectations regarding the costs and benefits of various programs we offer, including Club O and programs pursuant to which we offer free or discounted participation in Club O or other programs we offer to members of the United States Armed Forces and/or to full-time, post-secondary students or others, and including our community site and our public service pet adoption program;
- our belief that we and our fulfillment partners will be able to maintain inventory levels at appropriate levels despite the seasonal nature of our business;
- our belief that our sales through other ecommerce marketplace channels will be successful and will become an important part of our business; and
- our belief that we can successfully offer and sell a constantly changing mix of products and services.

Further, in some cases, you can identify forward-looking statements by terminology such as may, will, could, should, likely, expect, plan, seek, intend, anticipate, project, believe, estimate, predict, potential, goal, strategy, future or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially from those contemplated by forward-looking statements for a variety of reasons, including among others:

- changes in U.S. and global economic conditions and consumer spending;
- world events;
- the rate of growth of the Internet and online commerce, and the occurrence of any event that would discourage or prevent consumers from shopping online;
- any failure to maintain our existing relationships or build new relationships with fulfillment partners on acceptable terms;
- any difficulties we may encounter maintaining optimal levels of product quality and selection or in attracting sufficient consumer interest in our product offerings;
- modifications we may make to our business model from time to time, including aspects relating to our product mix and the mix of direct/fulfillment partner sourcing of the products we offer;
- the mix of products purchased by our customers;
- problems with cyber security or data breaches or Internet or other infrastructure or communications impairment problems or the costs of preventing or responding to any such problems;
- problems with or affecting our credit card processors, including cyber-attacks, Internet or other infrastructure or communications impairment or other events that could interrupt the normal operation of the credit card processors;
- problems with or affecting the facility where substantially all of our computer and communications hardware is located or other problems that result in the unavailability of our Website or reduced performance of our transaction systems;

- difficulties we may have in responding to technological changes;
- problems with the large volume of fraudulent purchase orders we receive on a daily basis;
- problems we may encounter as a result of the listing or sale of pirated, counterfeit or illegal items by third parties;
- difficulties we may have financing our operations or our expansion with either internally generated funds or external sources of financing;

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- any difficulties we may encounter relating to the real estate we recently purchased, the design and construction of an office campus on that property to serve as our corporate headquarters, the financing of a substantial portion of the costs of designing and constructing the office campus and headquarters or in financing it after construction, or the transition from our current facilities to new facilities;
- any difficulties we may encounter in connection with our Supplier Oasis Fulfillment Services and our efforts to provide multi-channel fulfillment services, our Farmers Market offerings, our insurance product offerings or our consumer finance offerings;
- any difficulties we may encounter as a result of our reliance on third parties that we do not control for the performance of critical functions material to our business;
- any difficulties we may encounter in connection with the rapid shift of ecommerce and online payments to mobile and multi-channel commerce and payments;
- the extent to which we owe income or sales taxes or are required to collect sales taxes or report sales or to modify our business model in order to avoid being required to collect sales taxes or report sales;
- any difficulties we may encounter as a consequence of accepting or holding bitcoins, whether as a result of regulatory, tax or other legal issues, technological issues, value fluctuations, lack of widespread adoption of bitcoins as an acceptable medium of exchange or otherwise;
- competition, including competition from well-established competitors including Amazon.com, and from others including competitors with business models that may include delivery capabilities that we may be unable to match;
- difficulties with the management of our growth and any periods in which we fail to grow in accordance with our plans;
- fluctuations in our operating results;
- our efforts to expand internationally;
- our efforts to offer additional types of services to our customers, including insurance products and consumer financing;
- the outcomes of legal proceedings, investigations and claims, including the outcome of our appeal of the judgment against us obtained by the District Attorneys of a number of California counties as described in this report;
- our inability to optimize our warehouse operations;
- risks of inventory management and seasonality;
- the cost and availability of traditional and online advertising, the rapid changes in the online advertising business and the longer-term changes in the traditional advertising business, and the results of our various brand building and marketing campaigns; and
- the other risks described in this report or in our other public filings.

In evaluating all forward-looking statements, you should specifically consider the risks outlined above and in this Form 10-Q in Part II, Item 1A under the caption “Risk Factors,” in Part I, Item 2 under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report. These factors may cause our actual results to differ materially from those contemplated by any forward-looking statement. Although we believe that our expectations reflected in the forward-looking statements are reasonable, we cannot guarantee or offer any assurance of future results, levels of activity, performance or achievements or other future events.

Our forward-looking statements contained in this report speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report or any changes in our expectations or any change in any events, conditions or circumstances on which any of our forward-looking statements are based.

Available Information

Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of

charge through the Investors Relations section of our main website www.overstock.com as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Our Internet Website and the information contained therein or connected thereto are not a part of or incorporated into this Quarterly Report on Form 10-Q.

Overview

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We are an online retailer offering discount brand name, non-brand name and closeout merchandise, including furniture, home decor, bedding and bath, housewares, jewelry and watches, apparel and designer accessories, electronics and computers, and sporting goods, among other products. We sell hundreds of thousands of best seller and current run books, magazines, CDs, DVDs and video games (“BMMG”). We sell these products and services through our Internet websites located at www.overstock.com, www.o.co and www.o.biz (“Website”). Although our three websites are located at different domain addresses, the technology and equipment and processes supporting the Website and the process of order fulfillment described herein are the same for all three websites.

Our company, based in Salt Lake City, Utah, was founded in 1997. We launched our initial website in March 1999. Our Website offers our customers an opportunity to shop for bargains conveniently, while offering our suppliers an alternative inventory liquidation or sales channel. We continually add new, and sometimes limited, inventory to our Website in order to create an atmosphere that encourages customers to visit frequently and purchase products before our inventory sells out. We sell products primarily in the United States.

As used herein, “Overstock,” “Overstock.com,”, “O.co,” “we,” “our” and similar terms include Overstock.com, Inc. and its subsidiaries, unless the context indicates otherwise.

Executive Commentary

This executive commentary is intended to provide investors with a view of our business through the eyes of our management. As an executive commentary, it necessarily focuses on selected aspects of our business. This executive commentary is intended as a supplement to, but not a substitute for, the more detailed discussion of our business included elsewhere herein. Investors are cautioned to read our entire “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” as well as our interim and audited financial statements, and the discussion of our business and risk factors and other information included elsewhere or incorporated in this report. This executive commentary includes forward-looking statements, and investors are cautioned to read the “Special Note Regarding Forward-Looking Statements” at the beginning of Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Revenues in Q3 2014 increased 17% compared to Q3 2013. The growth in revenue was primarily due to a 13% increase in orders, coupled with a 6% increase in average order size, from $170 to $180. These increases were partially offset by increased promotional activities including coupons, site sales, and Club O rewards (which we recognize as a reduction of revenue) due to driving a higher proportion of our sales using those channels. Although our average order size has increased in recent years, we expect the rate of increase to taper in the future.

Gross profit in Q3 2014 increased 13% compared to Q3 2013 primarily as a result of that revenue growth. Gross margin decreased to 19.0% in Q3 2014 compared to 19.6% in Q3 2013. The decrease in gross margin was largely due to increased promotional activities including coupons, site sales, and Club O rewards.

Sales and marketing expenses increased $2.9 million in Q3 2014 as compared to Q3 2013 primarily due to higher revenue. Sales and marketing expenses as a percentage of revenue decreased from 7.5% to 7.2% during Q3 2014 as compared to Q3 2013, primarily due to decreased spending in the sponsored search and offline advertising marketing channels as a percentage of revenue due to driving a smaller proportion of our revenue using those channels.

As a result of these factors, we had a 13% increase in Contribution during Q3 2014 as compared to Q3 2013 (see “Non-GAAP Financial Measures” below for a reconciliation of Contribution to Gross Profit). Contribution margin was 11.8% for Q3 2014 and 12.2% for Q3 2013.

Technology expenses in Q3 2014 increased $4.9 million compared to Q3 2013, primarily due to an increase in staff-related costs of $3.0 million and depreciation of $1.4 million. We continue to seek opportunities for growth in our business, including expanding our international sales and our distribution capabilities and multi-channel fulfillment services. We have also begun to broker insurance products, and offer consumer financing products through a third party, to our customers. We are also working to develop financial service software that utilizes the bitcoin network and its protocols. As a result of these and other initiatives, we expect to continue to increase our technology expenses, and these expenses may be material.

General and administrative expense in Q3 2014 increased $1.1 million compared to Q3 2013 primarily due to an increase of $2.4 million in staff and travel related costs, and a $565,000 increase in professional fees, partially offset by a decrease of $2.5 million in legal costs.

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We are constructing a new corporate headquarters in Salt Lake City, Utah. We estimate that the total project will cost approximately $96 million. In September 2014, we closed on the purchase of land in connection with the project for approximately $11.0 million which we funded with cash on hand. In October 2014, we entered in to a loan agreement which provides for an aggregate $56 million credit facility consisting of a term loan and revolving loan facility. This financing is discussed in further detail in the Liquidity and Capital Resources, Borrowings section below. We are in continuing discussions regarding future financing for equipment and furniture.

The balance of our Management's Discussion and Analysis of Financial Condition and Results of Operations provides further information about the matters discussed above and other important matters affecting our business.

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Results of Operations

The following table sets forth our results of operations expressed as a percentage of total net revenue:

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
	(as a percentage of total net revenue)		(as a percentage of total net revenue)	
Revenue, net				
Direct	9.5 %	11.8 %	10.2 %	12.6 %
Fulfillment partner	90.5	88.2	89.8	87.4
Total net revenue	100.0	100.0	100.0	100.0
Cost of goods sold				
Direct	8.3	10.2	9.0	11.0
Fulfillment partner	72.7	70.2	72.2	69.6
Total cost of goods sold	81.0	80.4	81.1	80.6
Gross profit	19.0	19.6	18.9	19.4
Operating expenses:				
Sales and marketing	7.2	7.5	7.0	6.7
Technology	6.3	5.7	6.2	5.9
General and administrative	4.8	5.3	4.7	5.3
Restructuring	—	—	—	(0.1)
Total operating expenses	18.3	18.5	17.9	17.7
Operating income	0.7	1.1	1.0	1.7
Interest income	—	—	—	—
Interest expense	—	—	—	—
Other income (expense), net	(0.1)	0.1	0.1	—
Net income before income taxes	0.6	1.2	1.1	1.7
Provision for income taxes	0.1	—	0.3	—
Net income	0.5 %	1.2 %	0.7 %	1.6 %

Comparisons of Three Months Ended September 30, 2014 to Three Months Ended September 30, 2013, and Nine Months Ended September 30, 2014 to Nine Months Ended September 30, 2013

Revenue

The following table reflects our net revenues for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2014	2013	$ Change	% Change	2014	2013	$ Change	% Change
Revenue, net								
Direct	$33,592	$35,681	$(2,089)	(5.9)%	$104,854	$113,873	$(9,019)	(7.9)%
Fulfillment partner	319,399	265,745	53,654	20.2	921,889	792,751	129,138	16.3
Total revenue, net	$352,991	$301,426	$51,565	17.1 %	$1,026,743	$906,624	$120,119	13.2 %

The primary reason for increased total net revenue for the three months ended September 30, 2014, as compared to the same period in 2013, was a 13% increase in orders coupled with a 6% increase in average order size, from $170 to $180. The primary reason for increased total net revenue for the nine months ended September 30, 2014, as compared

to the same period in 2013, was a 9% increase in orders, coupled with a 6% increase in average order size, from $163 to $174. These increases were partially offset by increased promotional activities including coupons, site sales, and Club O Rewards (which we

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recognize as a reduction of revenue) due to driving a higher proportion of our sales using those channels. Although our average order size has increased in recent years, we expect the rate of increase to taper in the future.

The primary reason for decreased direct revenue for the three months ended September 30, 2014, as compared to the same period in 2013, was a sales mix shift in bedding and bath products from our direct to fulfillment partner business.

The primary reason for decreased direct revenue for the nine months ended September 30, 2014, as compared to the same period in 2013, was a decrease in sales of clothing and shoes due to our shift from a direct inventory-based model to a fulfillment partner-based model to reduce exposure from seasonal inventory and mark downs.

The increase in fulfillment partner revenue for the three and nine months ended September 30, 2014, as compared to the same periods in 2013, was primarily due to an increase in sales of home and garden products. Notwithstanding this increase, we do not expect the sales mix shift to home and garden products to continue at the same rate in the future as in recent years.

The shift of business from direct to fulfillment partner (or vice versa) is an economic decision based on the economics of each particular product offering at the time and we generally do not have particular goals for an "appropriate" mix or percentage for the size of either. We believe that the mix of the business between direct and fulfillment partner is consistent with our strategic objectives for our business model in the current economic environment and we do not currently foresee any material shifts in mix.

We continue to seek increased participation in our Club O loyalty program as sales growth from customers with Club O memberships is typically higher than from other customers. For additional information regarding our Club O loyalty program see Item 1 of Part I, "Financial Statements (Unaudited)" -Note 2 -"Accounting Policies" under the section "Club O loyalty program." Additionally, we continue to experience increased visits and time spent on our website originating from mobile devices. Although the conversion rate of purchases from mobile devices is lower than from other sources (as is customary for our industry), we expect our mobile conversion rates to increase over time.

International sales were less than 2% of total net revenues for the three and nine months ended September 30, 2014 and 2013.

Change in estimate of average transit times (days)

Revenue related to merchandise sales is recognized upon delivery to our customers. As we ship high volumes of packages through multiple carriers, it is not practical for us to track the actual delivery date of each shipment. Therefore, we use estimates to determine which shipments are delivered and, therefore, recognized as revenue at the end of the period. Our delivery date estimates are based on average shipping transit times. We review and update our estimates on a quarterly basis based on our actual transit time experience. However, actual shipping times may differ from our estimates.

The following table shows the effect that hypothetical changes in the estimate of average shipping transit times would have had on the reported amount of revenue and net income for the three months ended September 30, 2014 (in thousands):

	Three Months Ended September 30, 2014	
Change in the Estimate of Average Transit Times (Days)	Increase (Decrease) Revenue	Increase (Decrease) Net Income

2	$(8,177)	$(1,318)
1	$(3,805)	$(590)
As reported	As reported	As reported
-1	$3,522	$546
-2	$11,450	$1,782

See “Executive Commentary” above for additional discussion regarding revenue.

Gross profit and gross margin

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Our overall gross margins fluctuate based on our sales volume mix between our direct business and fulfillment partner business; changes in vendor and / or customer pricing, including competitive pricing; inventory management decisions within the direct business; sales coupons and promotions; product mix of sales; and operational and fulfillment costs.

The following table reflects our net revenues, cost of goods sold and gross profit for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2014	2013	$ Change	% Change	2014	2013	$ Change	% Change
Revenue, net								
Direct	$33,592	$35,681	$(2,089)	(5.9)%	$104,854	$113,873	$(9,019)	(7.9)%
Fulfillment partner	319,399	265,745	53,654	20.2	921,889	792,751	129,138	16.3
Total net revenues	$352,991	$301,426	$51,565	17.1 %	$1,026,743	$906,624	$120,119	13.2 %
Cost of goods sold								
Direct	$29,385	$30,777	$(1,392)	(4.5)%	$91,955	$99,768	$(7,813)	(7.8)%
Fulfillment partner	256,548	211,499	45,049	21.3	741,109	630,931	110,178	17.5
Total cost of goods sold	$285,933	$242,276	$43,657	18.0 %	$833,064	$730,699	$102,365	14.0 %
Gross Profit								
Direct	$4,207	$4,904	$(697)	(14.2)%	$12,899	$14,105	$(1,206)	(8.6)%
Fulfillment partner	62,851	54,246	8,605	15.9	180,780	161,820	18,960	11.7
Total gross profit	$67,058	$59,150	$7,908	13.4 %	$193,679	$175,925	$17,754	10.1 %

Gross margins for the past seven quarterly periods and fiscal year ending 2013 were:

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	FY 2013	Q1 2014	Q2 2014	Q3 2014
Direct	11.4 %	12.2 %	13.7 %	13.4 %	12.7 %	13.0 %	11.3 %	12.5 %
Fulfillment Partner	20.0 %	20.8 %	20.4 %	18.6 %	19.8 %	19.5 %	19.7 %	19.7 %
Combined	18.9 %	19.7 %	19.6 %	18.0 %	19.0 %	18.8 %	18.8 %	19.0 %

The 122 basis point decrease in direct gross margin for the three months ended September 30, 2014, as compared to the same period in 2013, was primarily due to increased promotional activities which we recognize as a reduction of revenue (including coupons, site sales, and our Club O Rewards program) due to driving a higher proportion of our sales using those channels, and increased returns costs. These factors were partially offset by a continued shift in sales mix into higher margin home and garden products.

The 9 basis point decrease in direct gross margin for the nine months ended September 30, 2014, as compared to the same period in 2013, was primarily due to increased promotional activities (including coupons, site sales, and our Club O Rewards program), and increased returns costs. These increases were partially offset by a continued shift in sales mix into higher margin home and garden products.

The 74 and 80 basis point decreases in fulfillment partner gross margin for the three and nine months ended September 30, 2014, as compared to the same periods in 2013, respectively, were primarily due to increased promotional activities (including coupons, site sales, and our Club O Rewards program). The decrease for the three months ended September 30, 2014 was partially offset by a continued shift in sales mix into higher margin home and garden products.

Cost of goods sold includes stock-based compensation expense of $45,000 and $37,000 for the three months ended September 30, 2014 and 2013, respectively and $130,000 and $117,000 for the nine months ended September 30,

2014 and 2013, respectively.

See "Executive Commentary" above for additional discussion.

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Fulfillment costs

Fulfillment costs include all warehousing costs, including fixed overhead and variable handling costs (excluding packaging costs), as well as credit card fees and customer service costs, all of which we include as costs in calculating gross margin. We believe that some companies in our industry, including some of our competitors, account for fulfillment costs within operating expenses, and therefore exclude fulfillment costs from gross margin. As a result, our gross margin may not be directly comparable to others in our industry.

The following table has been included to provide investors additional information regarding our classification of fulfillment costs, gross profit and margin, thus enabling investors to better compare our gross margin with others in our industry (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2014		2013		2014		2013	
Total revenue, net	$352,991	100%	$301,426	100%	$1,026,743	100%	$906,624	100%
Cost of goods sold								
Product costs and other cost of goods sold	270,219	77%	228,963	76%	786,981	77%	690,563	76%
Fulfillment and related costs	15,714	4%	13,313	4%	46,083	4%	40,136	4%
Total cost of goods sold	285,933	81%	242,276	80%	833,064	81%	730,699	81%
Gross profit	$67,058	19%	$59,150	20%	$193,679	19%	$175,925	19%

Fulfillment costs as a percentage of sales may vary due to several factors, such as our ability to manage costs at our warehouses, significant changes in the number of units received and fulfilled, the extent to which we use third party fulfillment services and warehouses, and our ability to effectively manage customer service costs and credit card fees. Fulfillment and related costs as a percentage of revenue remained relatively flat during the three and nine months ended September 30, 2014 as compared to the same periods in 2013.

See “Gross profit” above for additional discussion.

Operating expenses

Sales and marketing expenses

We advertise through a number of targeted online marketing channels, such as sponsored search, affiliate marketing, portal advertising, e-mail campaigns, and other initiatives. We also use nationwide television, print and radio advertising campaigns to promote sales.

The following table reflects our sales and marketing expenses for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2014	2013	$ Change	% Change	2014	2013	$ Change	% Change
Sales and marketing expenses	$25,428	$22,463	$2,965	13.2 %	$72,363	$60,376	$11,987	19.9 %
Sales and marketing expenses as a percent of net revenues	7.2 %	7.5 %			7.0 %	6.7 %		

The 25 basis point decrease in sales are marketing expenses as a percentage of revenue for the three months ended September 30, 2014, as compared to the same period in 2013, was primarily due to decreased spending in the sponsored search and offline advertising marketing channels as a percentage of revenue due to driving a smaller proportion of our revenue using those channels.

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The 39 basis point increase in sales are marketing expenses as a percentage of revenue for the nine months ended September 30, 2014, as compared to the same period in 2013, was primarily due to increased spending in the sponsored search, display ad, email and affiliate marketing channels due to driving a higher proportion of our revenue through those channels.

Sales and marketing expenses include stock-based compensation expense of $77,000 and $44,000 for the three months ended September 30, 2014 and 2013, respectively and $255,000 and $123,000 for the nine months ended September 30, 2014 and 2013, respectively.

Costs associated with our discounted shipping and other promotions, such as coupons, site sales, and Club O Rewards, are not included in marketing expense. Rather, they are accounted for as a reduction of revenue and therefore affect revenues and gross margin. We consider discounted shipping and other promotions, such as our policy of free shipping on orders over $50 introduced in January 2013, as an effective marketing tool, and intend to continue to offer them as we deem appropriate as part of our overall marketing plan.

Technology expenses

We seek to invest efficiently in technology, including web services, customer support solutions, website search, expansion of new and existing product categories, and in investments in technology to enhance the customer experience, improve our process efficiency and support our logistics infrastructure. We continue to seek opportunities for growth in our business, including expanding our international sales and our distribution capabilities and multi-channel fulfillment services. We have also begun to broker insurance products, and offer consumer financing products through a third party, to our customers. We are also working to develop financial service software that utilizes the bitcoin network and its protocols, subject to the resolution of technical, legal, and regulatory constraints. As a result of these and other initiatives, we expect to continue to increase our technology expenses, and these expenses may be material.

We have noted a recent increase in the frequency and variety of cyber attacks on our website. The impact of these attacks, their costs, and the costs incurred to protect our website against future attacks have not been material. However, we consider the threat from cyber attacks to be serious and will continue to devote resources to protect against these threats.

The following table reflects our technology expenses for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2014	2013	$ Change	% Change	2014	2013	$ Change	% Change
Technology expenses	$22,202	$17,259	$4,943	28.6 %	$63,211	$53,339	$9,872	18.5 %
Technology expenses as a percent of net revenues	6.3 %	5.7 %			6.2 %	5.9 %		

The $4.9 million increase in technology costs for the three months ended September 30, 2014, as compared to the same period in 2013, was primarily due to an increase in staff related costs of $3.0 million and depreciation of $1.4 million.

The $9.9 million increase in technology costs for the nine months ended September 30, 2014, as compared to the same period in 2013, was primarily due to an increase in staff related costs of $5.5 million and depreciation of $2.2 million.

Technology expenses include stock-based compensation expense of $183,000 and $33,000 for the three months ended September 30, 2014 and 2013, respectively and $550,000 and $235,000 for the nine months ended September 30, 2014 and 2013, respectively.

General and administrative expenses

The following table reflects our general and administrative expenses for the three and nine months ended September 30, 2014 and 2013 (in thousands):

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	Three months ended September 30,				Nine months ended September 30,			
	2014	2013	$ Change	% Change	2014	2013	$ Change	% Change
General and administrative expenses	$17,073	$15,970	$1,103	6.9 %	$48,250	$47,643	$607	1.3 %
General and administrative expenses as a percent of net revenues	4.8 %	5.3 %			4.7 %	5.3 %		

The $1.1 million increase in general and administrative expenses ("G&A") for the three months ended September 30, 2014, as compared to the same period in 2013, was primarily due to an increase of $2.4 million in staff and travel related costs, and a $565,000 increase in professional fees, partially offset by a $2.5 million decrease in legal costs.

The $607,000 increase in G&A expenses for the nine months ended September 30, 2014, as compared to the same period in 2013, was primarily due to an increase of $4.5 million in staff and travel related costs, and a $1.1 million increase in professional fees, partially offset by a decrease of $5.8 million in legal costs.

G&A expenses include stock-based compensation expense of approximately $693,000 and $695,000 for the three months ended September 30, 2014 and 2013, respectively, and $2.0 million and $1.9 million for the nine months ended September 30, 2014 and 2013, respectively.

Restructuring

During the three months ended September 30, 2014 and 2013, we had zero lease termination costs. During the nine months ended September 30, 2014 and 2013 we reversed $360,000 and $471,000, respectively, of lease termination costs. These reversals were a result of our reoccupation of formerly restructured facility space. At September 30, 2014 our restructuring liability was zero.

Depreciation and amortization expense

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Cost of goods sold - direct	$61	$87	$217	$292
Technology	4,356	2,937	11,752	9,595
General and administrative	284	283	837	946
Total depreciation and amortization, including internal-use software and website development	$4,701	$3,307	$12,806	$10,833

Non-operating income (expense)

Interest income

Our interest income is primarily derived from the investment of our cash in cash equivalents and short-term investments. Interest income for the three months ended September 30, 2014 and 2013 totaled $36,000 and $34,000, respectively, and $114,000 and $100,000 for the nine months ended September 30, 2014 and 2013, respectively.

Interest expense

Our interest expense is primarily derived from interest incurred on our line of credit and our restructuring accrual. Interest expense for the three months ended September 30, 2014 and 2013 totaled $11,000 and $33,000, respectively, and $30,000 and $121,000 for the nine months ended September 30, 2014 and 2013, respectively. The decreases in interest expense are primarily due to the elimination of the restructuring accrual.

Other income (expense), net

Other income (expense), net for the three months ended September 30, 2014 was $(350,000) as compared to $165,000 in 2013. The decrease is primarily due to an increase in losses on precious metals of $659,000, partially offset by increased Club O Rewards and gift card breakage of $209,000.

Other income (expense), net for the nine months ended September 30, 2014 was $633,000 as compared to $360,000 in 2013. The increase is primarily due to an increase in gift card and Club O Rewards breakage of $622,000, partially offset by an increase in losses on precious metals of $277,000.

Income taxes

Our provision for income taxes for the three months ended September 30, 2014 and 2013 was $413,000 and $91,000, respectively. Our provision for income taxes for the nine months ended September 30, 2014 and 2013 was $3.4 million and $449,000, respectively. The increase in the 2014 provisions relative to the 2013 provisions is primarily due to a deferred tax asset valuation release in Q4 2013, which significantly reduced the 2013 provisions. The effective tax rate for the three months ended September 30, 2014 was 20.3%. The effective tax rate for the nine months ended September 30, 2014 was 31.4%. The variability in the effective tax rate is attributable to discrete items in the quarter including a change in estimated state research and experimentation credits. We have indefinitely reinvested foreign earnings of $105,000 at September 30, 2014. We would need to accrue and pay U.S. income tax on this amount if repatriated. We do not intend to repatriate these earnings.

Seasonality

Based upon our historical experience, revenue typically increases during the fourth quarter because of the holiday retail season and gross margin decreases due to increased sales of certain lower margin products, such as electronics. The actual quarterly results for each quarter could differ materially depending upon consumer preferences, availability of product and competition, among other risks and uncertainties. Accordingly, there can be no assurances that seasonal variations will not materially affect our results of operations in the future.

The following table reflects our total net revenues for each of the quarters in 2014, 2013 and 2012 (in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2014	$ 341,207	$ 332,545	$ 352,991	$ N/A
2013	311,994	293,204	301,426	397,593
2012	262,367	239,536	255,352	342,034

Liquidity and Capital Resources

Current sources of liquidity

Subject to our need for additional financing for a portion of the anticipated costs of completing our new corporate headquarters as described below, we believe that the cash and cash equivalents currently on hand and expected cash flows from future operations will be sufficient to continue operations for at least the next twelve months. However, we may require additional financing for the completion and ownership of the new corporate headquarters and related equipment and furniture. Although we are attempting to obtain additional financing, there can be no assurance that we will be able to do so or, that any financing available will be available on satisfactory terms. Our failure to generate sufficient revenues or profits or to obtain additional financing or raise additional capital could have a material adverse

effect on our operations and on our ability to achieve our intended business objectives. Any projections of future cash needs and cash flows are subject to substantial uncertainty.

As we have previously announced, we plan to build a new corporate headquarters in Salt Lake City, Utah. In September 2014 our wholly owned real estate subsidiary purchased the site for the headquarters for approximately $11 million in cash. On October 14, 2014 the subsidiary entered into a Construction Agreement dated October 13, 2014 relating to the construction of the future headquarters. (See "Construction Agreement" below.) We currently estimate the total cost of the headquarters, including the cost of the land and related equipment and furniture, at approximately $96 million.

On October 24, 2014, we entered into a syndicated senior secured credit facility with U.S. Bank National Association, and other banks which provides for an approximately 27-month construction loan of $45,760,000 (which is designed to subsequently convert into an approximately 6.75-year term loan following completion of the construction of the headquarters), and a three-year $10 million revolving loan facility that may be renewed with the consent of all lenders.

The actual amount of financing to be available under the construction loan facility will be limited by a loan-to-value limit of 80% based on periodic appraisals. The loan agreement requires us to fund a substantial portion of the project costs ($37.4 million) prior to any draws on either the term loan facility or the revolving facility. We have the right to prepay the term loan without penalty at any time.

If the conditions to the conversion of the construction loan into the term loan are not satisfied in early 2017, both the construction loan and the revolver would become due immediately.

The $10 million in financing to be available under the revolving loan facility may be used for working capital, capital expenditures and other corporate purposes, but may not be used for the construction of the headquarters. In order to draw on either the construction loan or the revolving loan we are required to satisfy a number of conditions set forth in the loan agreement. We do not expect to satisfy all of the conditions necessary for draws on the construction loan prior to approximately September 1, 2015. See “U.S. Bank Term Loan and Revolving Loan Agreement” below.

We are currently in discussions regarding additional financing for equipment and furniture for our new corporate headquarters.

Our principal sources of liquidity are cash flows generated from operations, and our existing cash and cash equivalents. At September 30, 2014, our only available credit facility was a $3.0 million facility solely to support letters of credit. At September 30, 2014, we had cash and cash equivalents of $112.7 million.

Cash flow information is as follows (in thousands):

	Nine months ended September 30,		Twelve months ended September 30,	
	2014	2013	2014	2013
Cash provided by (used in):				
Operating activities	$(496)	$13,784	$69,365	$55,266
Investing activities	(32,936)	(19,783)	(39,153)	(23,119)
Financing activities	(2,493)	(2,686)	(2,334)	(19,754)

Free Cash Flow

“Free Cash Flow” (a non-GAAP measure) for the nine months ended September 30, 2014 and 2013, was $(33.0) million and $(186,000), respectively, and $32.7 million and $39.4 million for the twe