BLUEFLY INC
Form 10-Q
November 07, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2005

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______

Commission File Number: 001-14498

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of November 3, 2005, the issuer had outstanding 17,373,288 shares of Common Stock, $.01 par value.

BLUEFLY, INC.
TABLE OF CONTENTS

PAGE

Part I . Financial Information

Item 1.	Financial Statements	
	Consolidated Condensed Balance Sheets as of September 30, 2005 and December 31, 2004 (unaudited)	3
	Consolidated Condensed Statements of Operations for the nine months ended September 30, 2005 and 2004 (unaudited)	4
	Consolidated Condensed Statements of Operations for the three months ended September 30, 2005 and 2004 (unaudited)	5
	Consolidated Condensed Statements of Cash Flows for the nine months ended September 30, 2005 and 2004 (unaudited)	6
	Notes to Consolidated Condensed Financial Statements (unaudited)	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	10
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	19
Item 4.	Controls and Procedures	19
Part II.	Other Information	20
Item 6.	Exhibits	20
Signatures		21

Part I - FINANCIAL INFORMATION

ITEM 1. - FINANCIAL STATEMENTS

BLUEFLY, INC.

CONSOLIDATED CONDENSED BALANCE SHEETS (Unaudited)

	SEPTEMBER 30, 2005
ASSETS	
Current assets	
Cash and cash equivalents	$ 5,120,000
Restricted cash	--
Inventories, net	17,216,000
Accounts receivable, net of allowance for doubtful accounts	1,943,000
Prepaid inventory	436,000
Prepaid expenses	1,292,000
Other current assets	539,000
Total current assets	26,546,000
Property and equipment, net	3,024,000
Other assets	329,000
Total assets	$ 29,899,000

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities	
Accounts payable	$ 4,464,000
Accrued expenses and other current liabilities	3,453,000
Notes payable to related party shareholders, includes interest payable of $1,067,000 at September 30, 2005	5,067,000
Deferred revenue	1,963,000
Total current liabilities	14,947,000
Notes payable to related party shareholders, includes interest payable of $658,000 at December 31, 2004	--
Long-term obligations under capital lease	40,000
Total liabilities	14,987,000
Commitments and contingencies	
Shareholders' equity	
Series A Preferred stock - $.01 par value; 500,000 shares authorized, 460,000 issued and outstanding as of September 30, 2005 and December 31, 2004, respectively (liquidation preference: $9.2 million plus accrued dividends of $5.6 million and $5.0 million as of September 30, 2005 and December 31, 2004, respectively)	5,000
Series B Preferred stock - $.01 par value; 9,000,000 shares authorized, 8,889,414 shares issued and outstanding as of September 30, 2005 and December 31, 2004, respectively (liquidation preference: $30 million plus accrued dividends of $9.0 million and $7.3 million as of September 30, 2005 and December 31, 2004, respectively)	89,000
Series C Preferred stock - $.01 par value; 3,500 shares authorized and 1,000 shares issued and outstanding as of September 30, 2005 and December 31, 2004, respectively (liquidation preference: $1 million plus accrued dividends of $261,000 and $191,000 as of September 30, 2005 and December 31, 2004, respectively)	--
Series D Preferred stock - $.01 par value; 7,150 shares authorized, 6,897.989 and 7,136.548 issued and outstanding as of September 30, 2005 and December 31, 2004, respectively (liquidation preference: $7.1 million plus accrued dividends of $2.3 million and $1.6 million as of September 30, 2005 and December 31, 2004, respectively)	--
Series E Preferred stock - $.01 par value; 1,000 shares authorized, issued and outstanding as of September 30, 2005 and December 31, 2004, respectively (liquidation preference: $1.0 million plus accrued dividends of $309,000 and $202,000 as of September 30, 2005 and December 31, 2004, respectively)	--
Series F Preferred stock - $.01 par value; 7,000 shares authorized, 6,438.571 issued and outstanding as of September 30, 2005 (liquidation preference: $7.0 million plus accrued dividends of $129,000 as of September 30, 2005)	--
Common stock - $.01 par value; 92,000,000 shares authorized and 16,424,524 and 15,241,756 shares issued and outstanding as of September 30, 2005 and December 31, 2004, respectively	164,000
Additional paid-in capital	114,546,000
Accumulated deficit	(99,892,000
Total shareholders' equity	14,912,000
Total liabilities and shareholders' equity	$ 29,899,000

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

BLUEFLY, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2005	2004
Net sales	$ 37,576,000	$ 29,284,000
Cost of sales	23,465,000	18,729,000
Gross profit	14,111,000	10,555,000
Selling, marketing and fulfillment expenses	12,671,000	9,718,000
General and administrative expenses	4,716,000	4,882,000
Total operating expenses	17,387,000	14,600,000
Operating loss	(3,276,000)	(4,045,000)
Interest and other income	134,000	815,000
Interest and other expense	(623,000)	(568,000)
Net loss	$ (3,765,000)	$ (3,798,000)
Preferred stock dividends	(3,671,000)	(3,176,000)
Net loss available to common shareholders	$ (7,436,000)	$ (6,974,000)
Basic and diluted loss per common share	$ (0.48)	$ (0.48)
Weighted average common shares outstanding (basic and diluted)	15,516,454	14,508,692

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

BLUEFLY, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,	
	2005	2004
Net sales	$ 12,045,000	$ 8,675,000
Cost of sales	7,470,000	5,709,000
Gross profit	4,575,000	2,966,000

Selling, marketing and fulfillment expenses	4,568,000	3,059,000
General and administrative expenses	1,528,000	1,736,000
Total operating expenses	6,096,000	4,795,000
Operating loss	(1,521,000)	(1,829,000)
Interest and other income	65,000	30,000
Interest and other expense	(247,000)	(161,000)
Net loss	$ (1,703,000)	$ (1,960,000)
Preferred stock dividends	(1,387,000)	(1,090,000)
Net loss available to common shareholders	$ (3,090,000)	$ (3,050,000)
Basic and diluted loss per common share	$ (0.20)	$ (0.21)
Weighted average common shares outstanding (basic and diluted)	15,823,602	14,634,625

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

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

	NINE MO SEPTE
	2005
Cash flows from operating activities	
Net loss	$ (3,765,000
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	930,000
Provisions for returns	309,000
Allowance for doubtful accounts	199,000
Reserve for inventory obsolescence	623,000
Change in value of warrants	--
Non-cash expense related to warrant issued to supplier	215,000
Stock option expense	35,000
Changes in operating assets and liabilities:	
(Increase) decrease in	
Inventories	(5,096,000
Accounts receivable	(933,000
Prepaid inventory	(352,000
Prepaid expenses	(996,000
Other current assets	434,000
Other assets	(187,000

Increase (decrease) in	
Accounts payable	274,000
Accrued expenses and other current liabilities	(284,000
Interest payable to related party shareholders	409,000
Deferred revenue	266,000
Net cash used in operating activities	(7,919,000
Cash flows from investing activities	
Cash collateral in connection with Rosenthal Pledge Agreement	1,250,000
Purchase of property and equipment	(2,011,000
Net cash used in investing activities	(761,000
Cash flows from financing activities	
Net proceeds from June 2005 Financing	6,752,000
Net proceeds from January 2004 Financing	--
Net proceeds from exercise of stock options	502,000
Payments of capital lease obligation	(139,000
Net cash (used in) provided by financing activities	7,115,000
Net (decrease) increase in cash and cash equivalents	(1,565,000
Cash and cash equivalents - beginning of period	6,685,000
Cash and cash equivalents - end of period	$ 5,120,000
Supplemental schedule of non-cash financing activities:	
Cash paid for interest	$ 120,000
Equipment acquired under capital lease	--

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

BLUEFLY, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS - Unaudited
SEPTEMBER 30, 2005

NOTE 1 - BASIS OF PRESENTATION

The accompanying consolidated condensed financial statements include the accounts of Bluefly, Inc. and its wholly owned subsidiary (collectively the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair statement have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company's Form 10-K for the year ended December 31, 2004.

The Company has sustained net losses and negative cash flows from operations since its formation. The Company's ability to meet its obligations in the ordinary course of business is dependent on its ability to establish profitable operations and/or raise additional financing through public or private debt or equity financing, or other sources to fund operations. The Company believes that its current funds, together with working capital, will be sufficient to enable it to meet its planned expenditures through at least March 31, 2006. If the Company does not achieve its sales plan, future operations may need to be modified, scaled back or discontinued.

NOTE 2 - THE COMPANY

The Company is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discounts of up to 75% off of retail value. The Company's e-commerce Web site ("Bluefly.com" or "Web Site") was launched in September 1998.

NOTE 3 - JUNE 2005 FINANCING

The Company raised over $7,000,000 in equity financing in June 2005. The financing was effected through a private placement (the "New Financing") that closed on June 24, 2005. The Company raised $7,075,431 through the sale of 7,000 shares of newly designated Series F Preferred Stock for an aggregate purchase price of $7,000,000 and warrants to purchase an additional 603,448 shares of its common stock at an exercise price of $2.87 per share. The warrants have an expiration date of June 24, 2008. The aggregate purchase price for the warrants was $75,431, or $0.125 per warrant, and all of the warrants were purchased by the New Investors described below. The investors participating in the New Financing included eight private equity funds that had not previously participated in the Company's financing transactions (the "New Investors"), and two private equity funds affiliated with Soros Fund Management LLC ("Soros") that collectively own a majority of the Company's capital stock. In connection with the New Financing, the New Investors also purchased from Soros previously issued shares of the Company's Series D Preferred Stock with an aggregate liquidation preference and accrued dividends of $3,000,000. Both the Series D Preferred Stock and the Series F Preferred Stock are convertible into common stock. The number of shares to be issued upon a conversion is determined by dividing the liquidation preference of the shares of preferred stock to be converted by the conversion price. The conversion price of the Series D Preferred Stock is $0.76 and the conversion price of the Series F Preferred Stock is $2.32. As of September 30, 2005, 238.559 shares of Series D Preferred Stock (plus all accrued and unpaid dividends payable on such shares) were converted into 414,815 shares of common stock and 561.429 shares of Series F Preferred Stock (plus all accrued and unpaid dividends payable on such shares) were converted into 247,180 shares of common stock, leaving 6,897.989 and 6,438.571 shares of Series D Preferred Stock and Series F Preferred Stock, respectively, issued and outstanding.

The majority of the proceeds of the New Financing are being used for marketing, with the remainder to be used for general corporate purposes.

NOTE 4 - NOTES PAYABLE TO RELATED PARTY SHAREHOLDERS

In February 2005, the Company extended the maturity dates on the Convertible Promissory Notes issued in July and October 2003 (the "Notes") to affiliates of Soros that collectively own a majority of the Company's capital stock. The maturity dates of the Notes were each extended for one year, from May 1, 2005 to May 1, 2006.

BLUEFLY, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS - Unaudited
SEPTEMBER 30, 2005

NOTE 5 - CREDIT FACILITY

In July 2005, the Company entered into a new three year revolving credit facility (the "Credit Facility") with Wells Fargo Retail Finance, LLC ("Wells Fargo"). The Credit Facility refinanced the Company's previous credit facility (the "Rosenthal Facility") with Rosenthal & Rosenthal, Inc. ("Rosenthal"). Under the terms of the Credit Facility, Wells Fargo provides the Company with a revolving credit facility and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on substantially all of the Company's assets, as well as a $2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. The maximum availability is currently $7,500,000 ($6,650,000 after giving effect to a required $850,000 availability reserve), but can be increased to $12,500,000 at the Company's request, subject to certain conditions. As of September 30, 2005, total availability under the Credit Facility, after giving effect to the required $850,000 availability reserve, was approximately $6,400,000, of which $2,700,000 was committed, leaving approximately $3,700,000 available for further borrowings. As a result of the refinancing of the Rosenthal Facility, the Company also regained access to approximately $1,250,000 of cash that had previously been restricted because it was being held as cash collateral by Rosenthal under the terms of the Rosenthal Facility.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75%. The Company also pays a monthly commitment fee on the unused portion of the facility (i.e., $7,500,000 less the amount of loans outstanding) equal to 0.35%. The Company also pays Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open. For the three months ended September 30, 2005, the Company incurred approximately $20,000 in connection with these fees.

Subject to certain conditions, if the Company defaults on any of its obligations under the Credit Facility, Wells Fargo has the right to draw upon the Soros LC to satisfy any such obligations. If Wells draws on the Soros LC, pursuant to the terms of a reimbursement agreement between the Company and Soros, the Company would have the obligation to, among other things, reimburse Soros for any amounts drawn under the Soros LC, plus interest accrued thereon. In addition, the Company is required to pay Soros Fund Management LLC an annual fee in connection with the issuance and maintenance of the Soros LC in an amount equal to the fee that the Company would be required to pay in order to have a similar letter of credit issued under the Credit Facility. For the year beginning on the date of the closing of the Credit Facility, this formula requires an annual fee of $55,000. The Company is also required to reimburse Soros for any costs and expenses associated with the issuance and maintenance of the Soros LC.

Under the terms of the Credit Facility, Soros has the right to purchase all of the Company's obligations from Wells at any time if the Company is then in default under the Credit Facility.

NOTE 6 - LOSS PER SHARE

The Company has determined Loss Per Share in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share." Basic

loss per share excludes dilution and is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period.

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

8

BLUEFLY, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS - Unaudited
SEPTEMBER 30, 2005

SECURITY	SEPTEMBER 30, 2005	EXERCISE PRICES	SEPTEMBER 30, 2004	EXERCISE
Options	9,054,230	$ 0.69 - $ 16.47	10,071,023	$ 0.69 - $
Warrants	1,933,393	$ 0.78 - $ 3.96	1,704,945	$ 0.78 - $
Preferred Stock	45,678,675(1)		43,323,430(1)	
Convertible Notes(2)	--		--	

(1) Excludes dividends on preferred stock, which are payable in cash or common stock, at the Company's option, upon conversion, redemption or liquidation.
(2) Excludes debt issued in connection with the July 2003 financing and October 2003 financing, which is convertible into equity securities of the Company sold in any subsequent round of financing, at the holders option, at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing. Until such financing occurs, such debt is not convertible into Common Stock.

NOTE 7 - STOCK BASED COMPENSATION

At September 30, 2005, the Company has three stock-based employee compensation plans. The Company applies Statement of Financial Accounting Standards ("SFAS") No. 148 "Accounting for Stock Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123," SFAS No. 123 "Accounting for Stock Based Compensation," and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its stock based compensation plan. In accordance with SFAS No. 123, the Company applies Accounting Principles Board Opinion No. 25 and related Interpretations for expense recognition. For the quarter ended September 30, 2005, compensation expense of $8,000 was recorded in connection with certain options issued below market value to the Company's Chief Executive Officer in accordance with the terms of her employment agreement. In addition, during the quarter ended September 30, 2004, $121,000 in compensation expense was recorded: $113,000 in connection with certain options issued to the Company's former Chief Executive Officer pursuant to his separation agreement; and $8,000 was recorded in connection with certain options issued below market value to the Company's Chief Executive Officer in accordance with the terms of her employment agreement. Except for these options, no additional compensation expense has been recorded for the three months ended September 30, 2005 and September 30, 2004 in

connection with stock option grants to employees, because the exercise price of employee stock options equals or exceeds the market price of the underlying stock on the date of grant. Had compensation expense for the Plan been determined consistent with the provisions of SFAS No. 123, the effect on the Company's basic and diluted net loss per share would have been as follows:

	FOR THE NINE MONTHS ENDED		FOR THE THREE MON	
	SEPTEMBER 30, 2005	SEPTEMBER 30, 2004	SEPTEMBER 30, 2005	SE
Net loss, as reported	$ (3,765,000)	$ (3,798,000)	$ (1,703,000)	$
Deduct: total stock based compensation expense determined under fair value based methods for all awards	(2,148,000)	(2,328,000)	(734,000)	
Add: Stock-based employee compensation expense included in net loss	35,000	123,000	8,000	
Adjusted for Preferred stock dividends	(3,671,000)	(3,176,000)	(1,387,000)	
Pro forma net loss available to common shareholders	(9,549,000)	(9,179,000)	(3,816,000)	
Loss per share				
Basic and diluted, as reported	$ (0.48)	$ (0.48)	$ (0.20)	$
Basic and diluted, pro forma	$ (0.62)	$ (0.63)	$ (0.24)	$

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces SFAS 123 and supersedes APB No. 25. Under the new standard, companies will no longer be able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB No. 25. Instead, companies will be required to account for such transactions using a fair-value method and to recognize the expense in the statements of income. The adoption of SFAS 123R will also require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R will be effective for annual periods beginning after June 15, 2005 and allows, but does not require, companies to restate prior periods. The Company is evaluating the impact of adopting SFAS 123R and expects that it will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on the Company's cash flows; however, the non-cash charges associated therewith are expected to have a significant, adverse effect on its results of operations.

The effects of applying SFAS No. 123R in this pro forma disclosure are not indicative of future amounts, as additional stock option awards are anticipated in future years.

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

OF OPERATIONS

OVERVIEW

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home furnishings at discounts of up to 75% off of retail value. We launched our Web site in September 1998. Over the past four years our sales have grown at a compounded annual growth rate of more than 25%, while our gross margin percentage has increased from 20% in 2000 to 37% in 2004.

The recent increase in our margin and sales is the direct result of a new merchandise strategy that we began to implement in spring 2004. As part of that strategy we are bringing current season merchandise and the latest fashion trends to our customer for great value. While there will be some fluctuation in our gross margin percentage from quarter to quarter as we further develop our merchandising and marketing strategy, we believe that we will be able to maintain margins well above our levels from 2003 and earlier.

Based on our improved merchandise strategy and recent customer research, we believe that there is an opportunity to accelerate the growth of our business while continuing to provide our customers with the great values that they have become accustomed to. In an effort to take advantage of this opportunity, we raised $7 million of equity financing in June and approximately $3.0 million of the proceeds is being used to launch a national advertising campaign. This campaign launched in September 2005. In addition, we secured a new $7.5 million credit facility with Wells Fargo Retail Finance, LLC ("Wells Fargo") in July of this year. This facility is primarily being used to help us obtain the proper merchandising mix to support the anticipated growth in demand from our national advertising campaign.

Our net sales increased approximately 39% to $12,045,000 for the third quarter ended September 30, 2005 from $8,675,000 for the third quarter ended September 30, 2004. Our gross margin increased to approximately 38% in the third quarter of 2005 from over 34% in the third quarter of 2004. Our gross profit increased by approximately 54% to $4,575,000 in third quarter of 2005, from $2,966,000 in the third quarter of 2004. This growth in gross profit was driven by the increase in net sales, and by the increase in gross margins. Our operating loss decreased by approximately 17%, to $1,521,000 in the third quarter of 2005, from $1,829,000 in the third quarter of 2004.

10

We increased our spending in marketing (excluding staff related costs) by 565% to $1,442,000 in the third quarter of 2005, from $217,000 in the third quarter of 2004. While some of the growth in sales was a result of our marketing initiatives, a large portion of the increased marketing expense was a result of the costs associated with our national advertising campaign, which was not launched in September 2005. Because the advertising campaign did not launch until the end of the quarter, we believe that its impact on our sales cannot yet fully be gauged. In general, we intend to market our business more aggressively than we have in previous years. This more aggressive growth strategy will cause our marketing expense as a percentage of revenue to increase in the short-term, however, we believe that it is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead on a customer's first order.

Our reserve for returns and credit card chargebacks increased to 39.4% of gross sales in the third quarter of 2005 compared to 37.2% in 2004. The increase was primarily caused by a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the

higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

A portion of our inventory includes merchandise that we either purchased with the intention of holding for the appropriate season or were unable to sell in a prior season and have determined to hold for the next selling season, subject (in some cases) to appropriate mark-downs. We have recently increased the amount of inventory purchased on a pack and hold basis in order to take advantage of opportunities in the market.

At September 30, 2005, we had an accumulated deficit of $99,892,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site and building our infrastructure, as well as non cash beneficial conversion charges resulting from decreases in the conversion price of our Preferred Stock. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. Therefore, we may continue to incur substantial operating losses. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

CRITICAL ACCOUNTING POLICIES

Management Estimates

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

Revenue Recognition

We recognize revenue in accordance with Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition in the Financial Statements" as amended. Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes. Revenue is recognized when all the following criteria are met:

- A customer executes an order.
- The product price and the shipping and handling fee have been determined.
- Credit card authorization has occurred and collection is reasonably assured.
- The product has been shipped and received by the customer.

Shipping and handling billed to customers are classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and

Handling Fees and Costs" ("EITF No. 00-10").

Provision for Returns and Doubtful Accounts

We generally permit returns for any reason within 90 days of the sale. Accordingly, we establish a reserve for estimated future returns and bad debt at the time of shipment based primarily on historical data. We perform credit card authorizations and check the verification of our customers prior to shipment of merchandise. However, our future return and bad debt rates could differ from historical patterns, and, to the extent that these rates increase significantly, it could have a material adverse effect on our business, prospects, cash flows, financial condition and results of operations.

Inventory Valuation

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. We review our inventory levels in order to identify slow-moving merchandise and establish a reserve for such merchandise.

Deferred Tax Valuation Allowance

We recognize deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income in the period that included the enactment date. We have assessed the future taxable income and determined that a 100% deferred tax valuation allowance is necessary. In the event that we were to determine that we would be able to realize our deferred tax assets, or a portion thereof, an adjustment to the deferred tax valuation allowance would increase income in the period such determination is made.

RESULTS OF OPERATIONS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2004

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

	2005		2004	
		As a % of Net Sales		As a Net
Net sales	37,576	100.0%	$ 29,284	
Cost of sales	23,465	62.4%	18,729	
Gross profit	14,111	37.6%	10,555	
Selling, marketing and fulfillment expenses	12,671	33.7%	9,718	
General and administrative expenses	4,716	12.6%	4,882	
Total operating expenses	17,387	46.3%	14,600	
Operating loss	(3,276)	(8.7)%	(4,045)	
Interest (expense) and other income	(489)	(1.3)%	247	

Net loss	(3,765)	(10.0)%	(3,798)

We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the nine months ended September 30th, as indicated below:

12

	2005	2004	2003
Average Order Size (including shipping & handling)	$ 214.07	$ 185.83	$ 168.03
New Customers Added during the Period*	95,088	84,605	79,134

* -- Based on unique email addresses.

Net sales: Gross sales (which includes sales of product and shipping revenue) for the nine months ended September 30, 2005 increased by over 29% to $61,092,000, from $47,188,000 for the nine months ended September 30, 2004. For the nine months ended September 30, 2005, we recorded a provision for returns and credit card chargebacks and other discounts of $23,516,000, or approximately 38.5% of gross sales. For the nine months ended September 30, 2004, the provision for returns and credit card chargebacks and other discounts was $17,904,000, or approximately 38.0% of gross sales.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the nine months ended September 30, 2005 were $37,576,000. This represents an increase of approximately 28% compared to the nine months ended September 30, 2004, in which net sales totaled $29,284,000. The growth in net sales resulted from both an increase in the number of new customers acquired (approximately 12% compared to the first nine months of 2004) and an increase in average order size (approximately 15% higher compared to the first nine months of 2004). For the nine months ended September 30, 2005, revenue from shipping and handling (which is included in net sales) increased by approximately 14% to $2,645,000 from $2,320,000 for the nine months ended September 30, 2004. Revenue from shipping and handling increased at a lower rate than overall revenue, due to the increase in our average order size.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the nine months ended September 30, 2005 totaled $23,465,000, resulting in gross margin of approximately 37.6%. Cost of sales for the nine months ended September 30, 2004 totaled $18,729,000, resulting in gross margin of 36.0%. The increase in gross margin percentage was primarily the result of our merchandise strategy and the timing of our promotions. Gross profit increased by nearly 34%, to $14,111,000 for the nine months ended September 30, 2005 compared to $10,555,000 for the nine months ended September 30, 2004.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 30% for the first nine months of 2005 compared to the first nine months of 2004. Selling, marketing and fulfillment expenses were comprised of the following:

	Nine Months Ended September 30, 2005	As a % of Net Sales	Nine Months Ended September 30, 2004	As a % of Net Sales	Perce Diffe increase
Marketing	$ 3,538,000	9.4%	$ 1,389,000	4.7%	
Operating	4,683,000	12.5%	3,891,000	13.3%	
Technology	2,680,000	7.1%	3,134,000	10.7%	
E-Commerce	1,770,000	4.7%	1,304,000	4.5%	
	$ 12,671,000	33.7%	$ 9,718,000	33.2%	

As a percentage of net sales, our selling, marketing and fulfillment expenses increased to 33.7% for the nine months ended September 30, 2005 from 33.2% for the nine months ended September 30, 2004. The increase in selling, marketing and fulfillment expenses as a percentage of net sales resulted primarily from costs associated with our national ad campaign (which was launched in September 2005). The increase was offset partially from economies of scale in our operations and technology expenses, as some of the fixed costs involved in maintaining our Web site and processing orders are allocated over a larger number of orders. One of our goals is to achieve greater economies of scale as our business grows, although there can be no assurance that we will be successful in doing so. We plan to continue to invest in all of these areas in the near term in order to grow our business.

13

Marketing expenses include expenses related to our national ad campaign, online and print advertising, "sweepstakes" promotions as well as staff related costs. Marketing expenses increased by a higher percentage than revenue as a result of the costs associated with our national marketing campaign. Costs in connection with this campaign are being recorded as the magazines and commercials are being released. For the nine months ended September 30, 2005, approximately $900,000 was expensed in connection with this campaign. As a result we expect marketing expense as a percentage of revenue to increase in the short-term. We believe that this is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead on a customer's first order.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in the first nine months of 2005 by approximately 20% compared to the first nine months of 2004 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees), as well as costs associated with our temporary clearance store, which closed in April.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the nine months ended September 30, 2005 technology expenses decreased by approximately 15% compared to the nine months ended September 30, 2004. This decrease resulted from a decrease in headcount and salary related expenses, a decrease in depreciation expense, a decrease in web hosting expense and was offset by an increase in the costs associated with software support. Depreciation expense for the nine months ended September 30, 2005 was lower than depreciation for the nine months ended September 30, 2004 due to the fact that some equipment was fully depreciated.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web site design. For the nine months ended September 30, 2005, this amount increased by approximately 36% as compared to the nine months ended

September 30, 2004, primarily due to an increase in salary related expenses as well as an increase in expenses associated with third party software and analytics and photo shoots.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the nine months ended September 30, 2005 decreased slightly by approximately 3% to $4,716,000 as compared to $4,882,000 for the nine months ended September 30, 2004. The decrease in general and administrative expenses was the result of decreased salary and benefit expenses, offset by an increase in public company expenses, and increases in consulting and accounting fees.

As a percentage of net sales, general and administrative expenses for the first nine months of 2005 decreased to approximately 12.6% from 16.7%.

Loss from operations: Operating loss decreased by 19% for the nine months ended September 30, 2005 to $3,276,000 from $4,045,000 in the nine months ended September 30, 2004 as a result of the increase in gross margin and revenue.

Interest and other income: Other income for the nine months ended September 30, 2005 decreased to $134,000 from $815,000 for the nine months ended September 30, 2004. Other income for the nine months ended September 30, 2005 consisted of interest income earned on our cash balance. Other income for the nine month period ended September 30, 2004 consisted of: (i) $564,000, which was recognized to adjust a liability associated with warrants issued by us to their fair value as of June 17, 2004 (at which time the warrants were re-classified as equity), (ii) $169,000 was realized in connection with the judgment we received in the Breider Moore litigation; and (iii) $82,000 of interest income on our cash balance.

Interest and other expense: Interest expense for the nine months ended September 30, 2005 increased to $623,000 from $568,000, and related primarily to fees paid in connection with the Credit Facility and interest expense on the Convertible Notes.

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2004

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

	2005		2004	
		As a % of Net Sales		As a Net
Net sales	$ 12,045	100.0%	$ 8,675	
Cost of sales	7,470	62.0%	5,709	
Gross profit	4,575	38.0%	2,966	
Selling, marketing and fulfillment expenses	4,568	37.9%	3,059	
General and administrative expenses	1,528	12.7%	1,736	

Total operating expenses	6,096	50.6%	4,795
Operating loss	(1,521)	(12.6)%	(1,829)
Interest (expense) and other income, net	(182)	(1.5)%	(131)
Net loss	(1,703)	(14.1)%	(1,960)

We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the three months ended September 30th, as indicated below:

	2005	2004	2003
Average Order Size (including shipping & handling)	$ 228.72	$ 179.48	$ 161.87
New Customers Added during the Period*	28,762	25,792	29,522

* -- Based on unique email addresses.

Net sales: Gross sales for the three months ended September 30, 2005 increased by nearly 44% to $19,878,000, from $13,819,000 for the three months ended September 30, 2004. For the three months ended September 30, 2005, we recorded a provision for returns and credit card chargebacks and other discounts of $7,832,000, or approximately 39.4% of gross sales. For the three months ended September 30, 2004, the provision for returns and credit card chargebacks and other discounts was $5,144,000, or approximately 37.2% of gross sales. The increase in this provision as a percentage of gross sales resulted from an increase in the return rate. The increase was primarily caused by a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the three months ended September 30, 2005 were $12,045,000. This represents an increase of approximately 39% compared to the three months ended September 30, 2004, in which net sales totaled $8,675,000. The growth in net sales resulted from both an increase in the number of new customers acquired (approximately 12% higher compared to second quarter 2004) and an increase in average order size (approximately 27% higher compared to the second quarter 2004). For the three months ended September 30, 2005, revenue from shipping and handling (which is included in net sales) increased by approximately 16% to $821,000 from $709,000 for the quarter ended September 30, 2004. Revenue from shipping and handling increased at a lower rate than overall revenue, due to the increase in our average order size.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the three months ended September 30, 2005 totaled $7,470,000, resulting in gross margin of approximately 38.0%. Cost of sales for the three months ended September 30, 2004 totaled $5,709,000, resulting in gross margin of 34.2%. The increase in gross margin percentage was the result of the timing of our promotions as well as a shift in our merchandising mix towards more current in season merchandise. While there will be some fluctuation in our gross margin percentage from quarter to quarter as we further develop our merchandising and marketing strategy, we believe that we

will be able to maintain margins well above our levels from 2003 and earlier. Gross profit increased by over 54%, to $4,575,000 for the three months ended September 30, 2005 compared to $2,966,000 for the three months ended September 30, 2004.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by over 49% in the second quarter of 2005 compared to the second quarter of 2004. Selling, marketing and fulfillment expenses were comprised of the following:

	Three Months Ended September 30, 2005	As a % of Net Sales	Three Months Ended September 30, 2004	As a % of Net Sales	Perce Diffe increase
Marketing	$ 1,603,000	13.3%	$ 365,000	4.2%	
Operating	1,475,000	12.2%	1,069,000	12.3%	
Technology	840,000	7.0%	1,114,000	12.8%	
E-Commerce	650,000	5.4%	511,000	5.9%	
	$ 4,568,000	37.9%	$ 3,059,000	35.2%	

As a percentage of net sales, our selling, marketing and fulfillment expenses increased to 37.9%.

Marketing expenses include expenses related to our national ad campaign, paid search, online and print advertising, fees to marketing affiliates, direct mail campaigns as well as staff related costs. Marketing expenses increased by a higher percentage than revenue as a result of the costs associated with our national marketing campaign. Costs in connection with this campaign are being recorded as the magazines and commercials are being released. For the three months ended September 2005, approximately $900,000 was expensed in connection with this campaign. As a result of our more aggressive growth strategy, we expect our marketing expense as a percentage of revenue to increase in the short-term. We believe that this is a prudent investment in our business given that our improved margin structure and average order size have historically resulted in a relatively high positive contribution to overhead on a customer's first order.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in the third quarter of 2005 by approximately 38% compared to the third quarter of 2004 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees). Operating expenses as a percentage of net sales remained relatively unchanged at 12%.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the three months ended September 30, 2005 technology expenses decreased by approximately 25% compared to the three months ended September 30, 2004. This decrease resulted from a decrease in salary related expenses, as well as a decrease in depreciation expense. Depreciation expense for the three months ended September 30, 2005 was lower than depreciation expense for the three months ended September 30, 2005 due to the fact that some equipment was fully depreciated and some software fully

amortized.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web site design. For the three months ended September 30, 2005, these expenses increased by approximately 27% as compared to the three months ended September 30, 2004, primarily due to an increase in salary related expenses, temporary help and photo shoots and consultants, as well as an increase in expenses associated with third party software and analytics.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the three months ended September 30, 2005 decreased by approximately 12% to $1,528,000 as compared to $1,736,000 for the three months ended September 30, 2004. General and administrative expenses for the third quarter 2004, included approximately $325,000 of expenses (including $113,000 of non-cash charges resulting from a stock option grant) incurred in connection with the separation agreement with our former CEO. The decrease in general and administrative expenses for the third quarter ended September 2005 compared to September 2004, was primarily the result of that charge as well as a decrease in public company expenses, recruiting expenses and legal fees, which was offset slightly by an increase in salary related expenses, depreciation and accounting fees.

As a percentage of net sales, general and administrative expenses for the third quarter of 2005 decreased to approximately 12.7% from 20.1%.

Loss from operations: Operating loss decreased by approximately 17% in the second quarter of 2005 to $1,521,000 from $1,829,000 in the third quarter of 2004 as a result of the increase in marketing spend.

Interest and other income: Other income for the three months ended September 30, 2005 increased to $65,000 from $30,000 for the three months ended September 30, 2004. In both periods this amount was related primarily to interest income.

Interest and other expense: Interest expense for the three months ended September 30, 2005 increased to $247,000 from $161,000, and related primarily to fees paid in connection with the Rosenthal Facility and interest expense on the Convertible Notes.

LIQUIDITY AND CAPITAL RESOURCES

General

At September 30, 2005, we had approximately $5.1 million entirely in the form of cash and cash equivalents, and working capital of approximately $11.6 million. Working capital at December 31, 2004 and September 30, 2004 were $12.8 and $7.6, respectively (both amounts exclude the approximately $1.25 million of restricted cash that we regained access to upon refinancing the Rosenthal Facility). In addition, as of September 30, 2005, we had approximately $2.7 million of borrowings committed under the Credit Facility, leaving approximately $3.7 million of availability. In June 2005 we completed a private placement (the "New Financing") pursuant to which we raised $7,075,431 through the sale of 7,000 shares of newly designated Series F Preferred Stock for an aggregate purchase price of $7,000,000 and warrants to purchase an additional 603,448 shares of our common stock at an exercise price of $2.87 per share. The purchase price for the warrants was $75,431, or $0.125 per warrant. Approximately $3,000,000 of the proceeds from the New Financing is being used to fund our national advertising campaign which launched this fall.

We fund our operations through cash on hand, operating cash flow, as well as the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance on these financial measures would have a negative impact on our liquidity. Total availability under the Credit Facility is based primarily upon our inventory levels. In addition, both availability under the Credit Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Wells Fargo to provide credit support under the Credit Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and financial press and elsewhere as to our financial strength. Accordingly, negative perceptions as to our financial strength could have a negative impact on our liquidity. In addition, newer vendors generally do not provide us with payment terms that are as favorable as those we get from existing relationships and, in some instances, new vendors may require prepayments. During 2005, we have increased our prepayments in order to open up new relationships and gain access to inventory that was not previously available to us. As of September 30, 2005, we had approximately $436,000 of prepaid inventory on our balance sheet.

In addition, our inventory levels as of September 30, 2005 are approximately $6.5 million higher than at the same time last year. The increase in inventory generally reflects opportunistic buying of fresh inventory that has not previously been available to us as well as our ramp up in anticipation of fourth quarter sales in connection with the holiday season. However, the increased inventory level, could adversely affect our flexibility in taking advantage of other buying opportunities that may become available in the near term

We believe that our current funds, together with working capital, will be sufficient to enable us to meet our planned expenditures through at least March 31, 2006. If the Company does not achieve its sales plan, future operations may need to be modified, scaled back or discontinued.

Credit Facility

In July 2005, we entered into a new three year revolving credit facility with Wells Fargo. Pursuant to the Credit Facility, Wells Fargo provides the Company with a revolving credit facility and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of the Company's assets, as well as a $2,000,000 letter of credit issued by Soros in

favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. The maximum availability is currently $7,500,000, but can be increased to $12,500,000 at the Company's request, subject to certain conditions. As of September 30, 2005, total availability under the Credit Facility, after giving effect to the required $850,000 availability reserve, was approximately $6,400,000 of which $2,700,000 was committed, leaving approximately $3,700,000 available for further borrowings.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75%. We also pay a monthly commitment fee on the unused portion of the facility (i.e., $7,500,000 less the amount of loans outstanding) equal to 0.35%. We also pay Wells Fargo certain fees to open

letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open.

Subject to certain conditions, if we default on any of our obligations under the Credit Facility, Wells Fargo has the right to draw upon the Soros LC to satisfy any such obligations. If Wells draws on the Soros LC, pursuant to the terms of a reimbursement agreement between us and Soros, we would have the obligation to, among other things, reimburse Soros for any amounts drawn under the Soros LC plus interest accrued thereon. In addition, we are required to pay Soros Fund Management LLC an annual fee in connection with the issuance and maintenance of the Soros LC in an amount equal to the fee that we would be required to pay in order to have a similar letter of credit issued under the Credit Facility. For the year beginning on the date of the closing of the Credit Facility this formula requires an annual fee of $55,000. We are also required to reimburse Soros for any costs and expenses associated with the issuance and maintenance of the Soros LC.

Under the terms of the Credit Facility, Soros has the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

Commitments and Long Term Obligations

As of September 30, 2005, we had the following commitments and long term obligations:

	Total	Less than 1 year	1-3 years	3-5 year
Marketing and Advertising	$ 1,522,000	1,522,000	--	
Purchase Orders	$ 7,012,000	7,012,000	--	
Operating Leases	$ 2,041,000	524,000	1,305,000	212
Capital Leases	$ 81,000	41,000	40,000	
Employment Contracts	$ 3,663,000	1,793,000	1,870,000	
Notes payable to shareholders, including interest payable	$ 5,067,000	5,067,000	--	
Grand total	$ 19,386,000	15,959,000	3,215,000	212

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

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2005 the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections." SFAS No. 154 replaces APB Opinion No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt this Statement beginning January 1, 2006.

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based

Payment" ("SFAS 123R"), which replaces SFAS 123 and supersedes APB No. 25. Under the new standard, companies will no longer be able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB No. 25. Instead, companies will be required to account for such transactions using a fair-value method and to recognize the expense in the statements of

income. The adoption of SFAS 123R will also require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R will be effective for annual periods beginning after June 15, 2005 and allows, but does not require, companies to restate prior periods. We are evaluating the impact of adopting SFAS 123R and expect that we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on our cash flows however the non-cash charges associated therewith are expected to have a significant, adverse effect on our results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES.

As of the end of the period covered by this Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer along with our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based upon that evaluation, our Chief Executive Officer along with our Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. There have been no changes in our internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

This report may include statements that constitute "forward-looking" statements, usually containing the words "believe", "project", "expect", or similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements. The risks and uncertainties are detailed from time to time in reports filed by us with the Securities and Exchange Commission, including Forms 8-A, 8-K, 10-Q, and 10-K. These risks and uncertainties include, but are not limited to, the following: our ability to execute on and gain additional revenue from, our consumer public relations and other marketing initiatives, our history of losses and anticipated future losses; need for additional capital and potential inability to raise such capital; the success of our new merchandising strategy; the risk of default by us under the Credit Facility and the consequences that might arise from us

having granted liens on substantially all of our assets under that agreement and the related Reimbursement Agreement with Soros; potential dilution arising from future equity financings, including potential dilution as a result of the anti-dilution provisions contained in our Preferred Stock and Convertible Notes; risks associated with Soros owning a majority of our stock; the potential failure to forecast revenues and/or to make adjustments to our operating plans necessary as a result of any failure to forecast accurately; unexpected changes in fashion trends; cyclical variations in the apparel and e-commerce markets; risks of litigation for sale of unauthentic or damaged goods and litigation risks related to sales in foreign countries; the dependence on third parties and certain relationships for certain services, including our dependence on U.P.S. (and the risks of a mail slowdown due to terrorist activity) and our dependence on our third-party web hosting, fulfillment and customer service centers; online commerce security risks; risks related to brand owners' efforts to limit our ability to purchase products indirectly; management of potential growth; the competitive nature of our business and the potential for competitors with greater resources to enter the business; the availability of merchandise; the need to further establish brand name recognition; risks associated with our ability to handle increased traffic and/or continued improvements to our Web site; rising return rates; dependence upon executive personnel; the successful hiring and retaining of new personnel; risks associated with expanding our operations; risks associated with potential infringement of other's intellectual property; the potential inability to protect our intellectual property; government regulation and legal uncertainties; uncertainties relating to the imposition of sales tax on Internet sales; and risks associated with the agreements with Soros with respect to a change of control and the liquidation preference of the Preferred Stock owned by Soros.

Part II - OTHER INFORMATION

ITEM 6. EXHIBITS

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

EXHIBIT NUMBER	DESCRIPTION
31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a)
31.2	Certification Pursuant to Rule 13a-14(a)/15d-14(a)
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

BLUEFLY, INC.

By: /s/ Melissa Payner-Gregor

Melissa Payner-Gregor
Chief Executive Officer

By: /s/ Patrick C. Barry

Patrick C. Barry
Chief Financial Officer

November 7, 2005