

Edgar Filing: BLUEFLY INC - Form 10-K

BLUEFLY INC
Form 10-K
March 03, 2005

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

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

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.

(Name of registrant as specified in its charter)

Delaware 13-3612110
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

42 West 39th Street, New York, NY 10018
(Address of principal executive offices) (Zip Code)

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

Securities registered under Section 12(b) of the Exchange Act: Common Stock, par value \$.01 per share

Securities registered under Section 12(g) of the Exchange Act: Common Stock, par value \$.01 per share

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 No

Indicate by check mark whether disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained in this form, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

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

As of February 24, 2005, there were 15,329,097 shares of Common Stock, \$.01 par value, of the registrant outstanding. The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2004, based upon the last sale price of such equity reported on the National Associated of

Edgar Filing: BLUEFLY INC - Form 10-K

Securities Dealers Automated Quotation SmallCap Market, was approximately \$9,933,000.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discounts up to 75% off retail value. During 2004, we offered over 27,000 different styles for sale in categories such as men's, women's and accessories as well as house and home accessories. We launched the Bluefly.com Web site (the "Web site") in September 1998. Since its inception, www.bluefly.com has served over 640,000 customers and shipped to over 20 countries.

Our common stock is listed on the Nasdaq SmallCap Market under the symbol "BFLY" and on the Boston Stock Exchange under the symbol "BFL" and we are incorporated in Delaware. Our executive offices are located at 42 West 39th Street, New York, New York 10018, and our telephone number is (212) 944-8000. Our Internet address is www.bluefly.com. We make available, free of charge, through our Web site, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

In this report, the terms "we," "us," "Bluefly" and the "Company" refer to Bluefly, Inc. and its predecessors and subsidiaries, unless the context indicates otherwise.

RECENT DEVELOPMENTS

In February 2005, we extended the maturity dates on the Convertible Promissory Notes issued to affiliates of Soros Private Equity Partners, LLC (collectively, "Soros") that collectively own a majority of our capital stock in July and October 2003 (the "Notes"). The maturity dates of the Notes were each extended for one year, from May 1, 2005 to May 1, 2006. Also in February 2005, we renewed our credit facility (the "Loan Facility") with Rosenthal & Rosenthal, Inc. ("Rosenthal") for an additional year, from March 30, 2005 to March 30, 2006.

BUSINESS STRATEGY

Our goal is to offer our customers the best designer brands, hottest fashion trends and superior values. We strive to offer the same types of on trend and in-season designer merchandise as are sold in luxury department stores such as Saks Fifth Avenue and Bergdorf Goodman at discounts normally found only at outlet stores and off-price stores such as T.J. Maxx and Ross Stores. We are able to acquire our products at significantly lower prices than a luxury department store (and pass these discounts on to our customers) because we purchase our inventory slightly later in the season than a typical full price retailer, at a time when vendors consider it to be excess inventory. Similarly, we are able to offer an upscale shopping experience not available at off-price stores or outlet malls because of our merchandise selection and the presentation and product search capabilities offered by our Web site.

Our business is also designed to provide a compelling value proposition for our suppliers and, in particular, the more than 350 top designer brands that we offer on our Web site. We recognize that liquidating excess inventory can be a "necessary evil" and that brand dilution can occur when a brand's product is

Edgar Filing: BLUEFLY INC - Form 10-K

offered in a traditional discount environment. We would like to make the liquidation of excess inventory a positive experience for our vendors rather than a distasteful one. We intend to do this by treating our suppliers with honesty and respect and by creating a high-end retail environment that offers only the best designer brands and the most current trends. In doing so, we hope to support our vendors' brands, rather than diluting them as traditional off-price channels do.

We do not believe that we can accomplish these goals without using the Internet as a platform. The direct marketing of products that are available in limited quantities and sizes, and that are not replenishable, requires a cost-effective medium that can display a large number of products, many of which are in limited supply, and some of which are neither available in all sizes nor easily replenished. We believe print catalogs are not well suited to this task. The paper, printing, mailing and other production costs of a print catalog can be significant and the lead times required to print a catalog make them significantly inflexible in addressing inventory sell outs, price changes and new styles. To work around these limitations, a traditional cataloger typically requires products that are replenishable, available in a full range of sizes and in substantial quantities. Similarly, retailing on television is costly and requires substantial quantities of products that are available in all sizes in order

2

for it to be an economical medium. In addition, the number of items that can be displayed on television is limited, and television does not allow viewers to search for products that interest them.

The Internet, however, can be a far less expensive and far more effective medium. By using the Internet as our platform, the number of items that we offer is not limited by the high costs of printing and mailing catalogs. With the Internet, we can automatically update product images as new products arrive and other items sell out. By using a real-time inventory database, we can create a personalized shopping environment and allow our customers to search for the products that specifically interest them and are available in their size. In addition, we believe that we are able to more economically and consistently maintain an upscale environment through the design of a single online storefront.

We believe that we have created a customer experience that is fundamentally better than that offered by traditional off-price retailers. Similarly, we believe that our upscale atmosphere, professional photography and premium merchandise offering create a superior distribution channel for designers who wish to liquidate their end-of-season and excess merchandise without suffering the brand dilution inherent in traditional off-price channels.

E-COMMERCE AND THE ONLINE APPAREL MARKET

The dramatic growth of e-commerce has been widely reported and is expected to continue. According to the ComScore Networks, online sales grew in 2004 by 26% over the \$93.2 billion spent in 2003. During the holiday shopping season alone, consumers spent \$23.6 billion, a 28% increase over the \$18.3 billion spent in the previous year, according to ComScore. We believe that a number of factors will contribute to the growth of e-commerce, including (i) shoppers' growing familiarity and comfort with shopping online, (ii) the proliferation of devices to access the Internet, and (iii) technological advances that make navigating the Internet faster and easier.

Forrester Research predicts that online sales of apparel will top \$13.8 billion in 2004, which makes it the single largest category of merchandise sold online.

Edgar Filing: BLUEFLY INC - Form 10-K

According to Forrester, 12% of all apparel sales will be made online by 2010, up from 7% in 2004. We believe that the market for online sales of apparel is growing faster than many other retail categories as a result of a confluence of trends, including (i) the growth of the number of women online, who account for a larger share of retail apparel purchases, (ii) the expansion of online traffic from technology oriented users to users with mainstream demographic, (iii) the development of sophisticated tools to search complex product categories such as apparel and (iv) the growing adoption of high speed access of cable modems and DSL, which makes viewing large numbers of photos much faster. Of course, there can be no assurance that such expectations will prove to be correct or that they will have a positive effect on our business.

MARKETING

Our marketing efforts are focused both on acquiring new customers and retaining existing customers. During the past several years, we have acquired new customers primarily through online advertising, word-of-mouth, sweepstakes and our affiliate program. Although we have not allocated significant resources to branding or to more traditional advertising channels such as print during this time, we may begin to do so as we seek to more aggressively promote the growth of our business. A significant portion of our sales to existing customers are driven by our customer emails, which highlight new promotions and products and provide special previews to customers who have asked to be included in our email list. In addition, we believe that our sales to existing customers are driven by all aspects of our customer experience, including our Web site design, packaging, delivery and customer service.

MERCHANDISING

We buy merchandise directly from designers as well as from retailers and other third party, indirect resources. Currently, we offer products from more than 350 name brand designers, which we believe to be the widest selection of designers available from any online store. We have established direct supply relationships with over 200 such designers. We believe that we have been successful in opening up over 200 direct supply relationships, in part because we have devoted substantial resources to establishing Bluefly.com as a high-end retail environment. We are committed to displaying all of our merchandise in an attractive manner, offering superior customer service and gearing all aspects of our business towards creating a better channel for top designers.

3

During 2004, we re-focused our merchandising strategy to offer more in-season merchandise and to cover the latest trends, while continuing to offer a premium selection of brands. As a result of this merchandise strategy, we were able to increase our gross margins to their highest levels ever - 37.5%, from 29.9%, 32.8% and 30.5% in 2003, 2002 and 2001, respectively.

WAREHOUSING AND FULFILLMENT

When we receive an order, the information is transmitted to our third party warehouse and fulfillment center located in Virginia, where the items included in the order are picked, packed and shipped directly to the customer. Our inventory database is updated on a real-time basis, allowing us to display on our Web site only those styles, sizes and colors of product available for sale.

We focus on customer satisfaction throughout our organization. In December 2004, during our peak weeks of the holiday season, the vast majority of our orders were shipped within one business day from receipt of the customer's order.

CUSTOMER SERVICE

Edgar Filing: BLUEFLY INC - Form 10-K

We believe that a high level of customer service and support is critical to differentiating ourselves from traditional off-price retailers and maximizing customer acquisition and retention efforts. Our customer service effort starts with our Web site, which is designed to provide an intuitive shopping experience. An easy to use help center is available on the Web site and is designed to answer many of our customers' most frequently asked questions. For customers who prefer e-mail or telephone assistance, customer service representatives are available seven days a week to provide assistance. We utilize customer representatives from a third party call center that has a team dedicated to our business. We also maintain a team of premiere representatives in our New York office, who provide special services and assist in the training and management of the other representatives. To insure that customers are satisfied with their shopping experience, we generally allow returns for any reason within 90 days of the sale for a full refund.

TECHNOLOGY

We have implemented a broad array of state-of-the-art technologies that facilitate Web site management, complex database search functionality, customer interaction and personalization, transaction processing, fulfillment and customer service functionality. Such technologies include a combination of proprietary technology and commercially available, licensed technology. To address the critical issues of privacy and security on the Internet, we incorporate, for transmission of confidential personal information between customers and our Web server, Secure Socket Layer Technology ("SSL") such that all data is transmitted via a 128-bit encrypted session. The computer and communications equipment on which our Web site is hosted are currently located at a single third party co-location facility in New Jersey. During the first half of 2005 we intend to move to a new co-location facility owned by a different third party located in New York.

COMPETITION

Electronic commerce generally, and, in particular, the online retail apparel and fashion accessories market, is a relatively new, dynamic, high-growth market. Our competition for online customers comes from a variety of sources, including existing land-based retailers such as Neiman Marcus, Saks Fifth Avenue, Bergdorf Goodman, The Gap, Nordstrom, and Macy's that are using the Internet to expand their channels of distribution, established Internet companies such as Amazon.com, Overstock.com and ebay.com and less established companies such as eLuxury and Yoox. In addition, our competition for customers comes from traditional direct marketers such as L.L. Bean, Lands' End, and J.Crew, designer brands that may attempt to sell their products directly to consumers through the Internet and land-based off-price retail stores, such as T.J. Maxx, Marshalls, Filene's Basement and Loehmanns, which may or may not use the Internet in the future to grow their customer base. Many of these competitors have longer operating histories, significantly greater resources, greater brand recognition and more firmly established supply relationships. Moreover, we expect additional competitors to emerge in the future.

We believe that the principal competitive factors in our market include: brand recognition, merchandise selection, price, convenience, customer service, order delivery performance and site features. Although we believe that we compare favorably with our competitors, we recognize that this market is relatively new and is evolving rapidly, and, accordingly, there can be no assurance that this will continue to be the case.

INTELLECTUAL PROPERTY

Edgar Filing: BLUEFLY INC - Form 10-K

We rely on various intellectual property laws and contractual restrictions to protect our proprietary rights in services and technology, including confidentiality, invention assignment and nondisclosure agreements with employees and contractors. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without our authorization. In addition, we pursue the registration of our trademarks and service marks in the U.S. and internationally and the registration of our domain name and variations thereon. However, effective intellectual property protection may not be available in every country in which the services are made available online.

We rely on technologies that we license from third parties. These licenses may not continue to be available to us on commercially reasonable terms in the future. As a result, we may be required to obtain substitute technology of lower quality or at greater cost, which could materially adversely effect our business, financial condition, results of operations and cash flows.

We do not believe that our business, sales policies or technologies infringe the proprietary rights of third parties. However, third parties have in the past and may in the future claim that our business, sales policies or technologies infringe their rights. We expect that participants in the e-commerce market will be increasingly subject to infringement claims as the number of services and competitors in the industry grows. Any such claim, with or without merit, could be time consuming, result in costly litigation or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements might not be available on terms acceptable to us, or at all. As a result, any such claim of infringement against us could have a material adverse effect upon our business, financial condition, results of operations and cash flows.

GOVERNMENTAL APPROVALS AND REGULATIONS

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. We are not aware of any permits or licenses that are required in order for us, generally, to sell apparel and fashion accessories on the Internet, although licenses are sometimes required to sell products made from specific materials. In addition, permits or licenses may be required from international, federal, state or local governmental authorities to operate or to sell certain other products on the Internet in the future. No assurances can be given that we will be able to obtain such permits or licenses. We may be required to comply with future national and/or international legislation and statutes regarding conducting commerce on the Internet in all or specific countries throughout the world. No assurance can be made that we will be able to comply with such legislation or statutes. Our Internet operations are not currently impacted by federal, state, local and foreign environmental protection laws and regulations.

EMPLOYEES

As of February 18, 2005, we had 73 full-time employees and 4 part-time employees, as compared to 89 full-time and 3 part-time employees as of February 18, 2004. None of our employees are represented by a labor union and we consider our relations with our employees to be good.

RISK FACTORS

We Have A History Of Losses And Expect That Losses Will Continue In The Future. As of December 31, 2004, we had an accumulated deficit of \$96,127,000. We incurred net losses of \$3,791,000, \$6,369,000 and \$6,479,000 for the years ended December 31, 2004, 2003 and 2002, respectively. We have incurred substantial costs to develop our Web site and infrastructure. In order to expand our

Edgar Filing: BLUEFLY INC - Form 10-K

business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore expect to continue to incur substantial operating losses for the foreseeable future. Our ability to become profitable depends on our ability to generate and sustain substantially higher net sales while maintaining reasonable expense levels, both of which are uncertain. If we do achieve profitability, we cannot be certain that we would be able to sustain or increase profitability on a quarterly or annual basis in the future.

We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds. We may need additional financing to effect our business plan and accelerate our customer acquisition. The environment for raising investment

5

capital has been difficult and there can be no assurance that additional financing or other capital will be available upon terms acceptable to us, or at all. In the event that we are unable to obtain additional financing, if needed, we could be forced to decrease expenses that we believe are necessary for us to realize on our long-term prospects for growth and profitability and/or liquidate inventory in order to generate cash. Moreover, any additional equity financing that we may raise could result in significant dilution of the existing holders of common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution Of Your Ownership Of Common Stock."

Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility. Under the terms of the Loan Facility, Rosenthal provides us with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to our suppliers. Pursuant to the Loan Facility, we gave a first priority lien to Rosenthal on substantially all of our assets, including our cash balances. If we default under the Loan Facility, Rosenthal would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the Loan Facility.

Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan. We are required to pay interest under our Loan Facility on a monthly basis. In addition, we are required, under the facility, to maintain working capital of at least \$6.0 million and net tangible worth of at least \$7.0 million as of the end of each fiscal year. Assuming we meet our business plan, we will satisfy these covenants. To a certain extent, however, our ability to meet our business plan, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control, and therefore we cannot assure you that based on our business plan we will generate sufficient cash flow from operations to enable us to pay our indebtedness under the Loan Facility and maintain compliance with our net working capital covenant throughout the term of the agreement or that we will be able to maintain compliance with the net worth covenant. If we fall short of our business plan and are unable to raise additional capital, we could default under our Loan Facility. In the event of a default under the Loan Facility, Rosenthal would be entitled, among other things, to foreclose on our assets (whether inside or outside a bankruptcy proceeding) in order to satisfy our obligations under the Loan Facility. See "Risk Factors - Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility."

Certain Events Could Result In Significant Dilution Of Your Ownership Of Our Common Stock. Stockholders could be subject to significant dilution to the extent that we raise additional equity financing, as a result of both the issuance of additional equity securities, the potential conversion of the

Edgar Filing: BLUEFLY INC - Form 10-K

convertible promissory notes described below and the anti-dilution provisions of our Series B, C, D and E preferred stock described below, which provide for the issuance of additional securities to the holders thereof, under certain circumstances, to the extent that the Preferred Stock is converted at any time after a sale of Common Stock at less than \$0.76 per share.

Moreover, as of February 18, 2005, there were outstanding options to purchase 8,750,680 shares of our Common Stock issued under our Stock Option Plans, warrants to purchase 981,644 shares of our Common Stock issued to Soros, and additional warrants and options to purchase 723,301 shares of our Common Stock. In addition, as of such date, our outstanding Preferred Stock was convertible into an aggregate of 43,323,430 shares of our Common Stock (plus any shares of our Common Stock issued upon conversion in payment of any accrued and unpaid dividends). The exercise of our outstanding options and warrants and/or the conversion of our outstanding Preferred Stock would dilute the then existing stockholders' percentage ownership of our common stock, and any sales in the public market of our Common Stock underlying such securities, could adversely affect prevailing market price of our Common Stock. In the event that all of the securities described above were converted to Common Stock, the holders of the Common Stock immediately prior to such conversion would own approximately 22% of the outstanding Common Stock immediately after such conversion, excluding the effect of accrued dividends on Preferred Stock.

As described above, our Series B, C, D and E Preferred Stock contain anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that we issue or sell our Common Stock or new securities convertible into our Common Stock in the future for less than \$0.76 per share, the number of shares of our Common Stock to be issued upon the conversion of such Preferred Stock would be increased to a number equal to the face amount of such Preferred Stock divided by the price at which such Common Stock or other new securities are sold.

In addition, Soros owns \$4 million of convertible promissory notes issued by us that bear interest at the rate of 12% per annum and are convertible, at Soros' option, into our equity securities sold in any subsequent round of financing at a price that is equal

6

to the lowest price per share accepted by any investor (including Soros or any of its affiliates) in such subsequent round of financing.

Soros Owns A Majority Of Our Stock And Therefore Effectively Controls Our Management And Policies. As of February 18, 2005, through its holdings of our common stock, as well as our preferred stock, and warrants convertible into our common stock, Soros beneficially owned, in the aggregate, approximately 84% of our common stock. The holders of our preferred stock vote on an "as converted" basis with the holders of our common stock. By virtue of its ownership of our preferred stock, Soros has the right to appoint two designees to our Board of Directors, each of whom has seven votes on any matter voted upon by our Board of Directors. Collectively, these two designees have 14 out of 19 possible votes on each matter voted upon by our Board of Directors. In addition, we are required to obtain the approval of holders of our preferred stock prior to taking certain actions. The holders of our preferred stock have certain pre-emptive rights to participate in future equity financings and certain anti-dilution rights that could result in the issuance of additional securities to such holders. In view of their large percentage of ownership and rights as the holders of our preferred stock, Soros effectively controls our management and policies, such as the election of our directors, the appointment of new management and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation, a sale of all or

Edgar Filing: BLUEFLY INC - Form 10-K

substantially all of our assets or a merger. In addition, Soros has demand registration rights with respect to the shares of our common stock that it beneficially owns. Any decision by Soros to exercise such registration rights and to sell a significant amount of our shares in the public market could have an adverse effect on the price of our common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution of Your Ownership Of Common Stock."

If We Are Not Accurate In Forecasting Our Revenues, We May Be Unable To Adjust Our Operating Plans In A Timely Manner. Because our business has not yet reached a mature stage, it is difficult for us to forecast our revenues accurately. We base our current and future expense levels and operating plans on expected revenues, but in the short term a significant portion of our expenses are fixed. Accordingly, we may be unable to adjust our spending in a timely manner to compensate for any unexpected revenue shortfall. This inability could cause our operating results in some future quarter to fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock could decline significantly. In addition any such unexpected revenue shortfall could significantly affect our short-term cash flow and our net worth, which could require us to seek additional financing and/or cause a default under our credit facility. See "Risk Factors - We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds" and "Risk Factors -Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan."

Unexpected Changes In Fashion Trends Could Cause Us To Have Either Excess or Insufficient Inventory. Fashion trends can change rapidly, and our business is sensitive to such changes. There can be no assurance that we will accurately anticipate shifts in fashion trends and adjust our merchandise mix to appeal to changing consumer tastes in a timely manner. If we misjudge the market for our products or are unsuccessful in responding to changes in fashion trends or in market demand, we could experience insufficient or excess inventory levels or higher markdowns, either of which would have a material adverse effect on our business, financial condition and results of operations.

We Will Be Subject To Cyclical Variations In The Apparel And E-Commerce Markets. The apparel industry historically has been subject to substantial cyclical variations. Furthermore, Internet usage slows down in the summer months. We and other apparel vendors rely on the expenditure of discretionary income for most, if not all, sales. In the first three quarters of 2003, the retail apparel market experienced sluggish growth, requiring many retailers to significantly reduce prices and discount merchandise. We lowered our prices during the first quarter of 2003, in part, as the result of this sluggish growth, and maintained lower pricing levels in the second and third quarters of 2003 in order to generate cash from excess out-of-season inventory. While the retail apparel market improved modestly during the fourth quarter of 2003 and the 2004 calendar year, any future decrease in growth rates or downturn, whether real or perceived, in economic conditions or prospects could adversely affect consumer spending habits and, therefore, have a material adverse effect on our revenue, cash flow and results of operations. Alternatively, any improvement, whether real or perceived, in economic conditions or prospects could adversely impact our ability to acquire merchandise and, therefore, have a material adverse effect on our business, prospects, financial condition and results of operations, as our supply of merchandise is dependent on the inability of designers and retailers to sell their merchandise in full-price venues. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority Of Our Vendors And Therefore The Availability of Merchandise Is At Risk."

We Purchase Product From Some Indirect Supply Sources, Which Increases Our Risk

Edgar Filing: BLUEFLY INC - Form 10-K

of Litigation Involving The Sale Of Non-Authentic Or Damaged Goods. We purchase merchandise both directly from brand owners and indirectly from retailers and third party distributors. The purchase of merchandise from parties other than the brand owners increases the risk that we will mistakenly purchase and sell non-authentic or damaged goods, which could result in potential liability under applicable laws, regulations, agreements and orders. Moreover, any claims by a brand owner, with or without merit, could be time consuming, result in costly litigation, generate bad publicity for us, and have a material adverse impact on our business, prospects, financial condition and results of operations.

If Our Co-Location Facility, Third Party Distribution Center Or Third Party Call Center Fails, Our Business Could Be Interrupted For A Significant Period Of Time. Our ability to receive and fulfill orders successfully and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications hardware systems and fulfillment center. Substantially all of our computer and communications hardware is located at a single co-location facility owned by a third party in New Jersey, and during the first half of 2005, we intend to move to a new co-location facility owned by a different third party in New York. Primarily all of our inventory is held, and our customer orders are filled, at a third party distribution center located in Virginia, and a large majority of our customer service representatives are employees of a third party call center in Ohio. These operations are vulnerable to damage or interruption from fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not presently have redundant systems in multiple locations or a formal disaster recovery plan. Accordingly, a failure at one of these facilities could interrupt our business for a significant period of time, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Any such interruption would negatively impact our sales, results of operations and cash flows for the period in which it occurred, and could have a long-term adverse effect on our relationships with our customers and suppliers.

Security Breaches To Our Systems And Database Could Cause Interruptions To Our Business And Impact Our Reputation With Customers, And We May Incur Significant Expenses To Protect Against Such Breaches. A fundamental requirement for online commerce and communications is the secure transmission of confidential information over public networks. There can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments will not result in a compromise or breach of the algorithms we use to protect customer transaction and personal data contained in our customer database. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation with customers, thereby affecting our long-term growth prospects. In addition, we may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches.

Brand Owners Could Establish Procedures To Limit Our Ability To Purchase Products Indirectly. Brand owners have implemented, and are likely to continue to implement, procedures to limit or control off-price retailers' ability to purchase products indirectly. In addition, several brand owners in the U.S. have distinctive legal rights rendering them the only legal importer of their respective brands into the U.S. If we acquire such product indirectly from distributors and other third parties who may not have complied with applicable customs laws and regulations, such goods could be subject to seizure from our inventory by U.S. Customs Service, and the importer may have a civil action for damages against us. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority of Our Vendors And Therefore The Availability Of Merchandise Is At Risk."

Edgar Filing: BLUEFLY INC - Form 10-K

Our Growth May Place A Significant Strain On Our Management And Administrative Resources And Cause Disruptions In Our Business. Our historical growth has placed, and any further growth is likely to continue to place, a significant strain on our management and administrative resources. To be successful, we must continue to implement information management systems and improve our operating, administrative, financial and accounting systems and controls. We will also need to train new employees and maintain close coordination among our executive, accounting, finance, marketing, merchandising, operations and technology functions. Any failure to implement such systems and training, and to maintain such coordination, could affect our ability to plan for, and react quickly to, changes in our business and, accordingly, could cause an adverse impact on our cash flow and results of operations in the periods during which such changes occur. In addition, as our workforce grows, our exposure to potential employment liability issues increases, and we will need to continue to improve our human resources functions in order to protect against such increased exposure. Moreover, our business is dependent upon our ability to expand our third-party fulfillment operations, customer service operations, technology infrastructure, and inventory levels to accommodate increases in demand, particularly during the peak holiday selling season.

8

Our planned expansion efforts in these areas could cause disruptions in our business. Any failure to expand our third-party fulfillment operations, customer service operations, technology infrastructure or inventory levels at the pace needed to support customer demand could have a material adverse effect on our cash flow and results of operations during the period in which such failures occur and could have a long-term effect on our reputation with our customers.

We Are Heavily Dependent On Third-Party Relationships, And Failures By A Third Party Could Cause Interruptions To Our Business. We are heavily dependent upon our relationships with our fulfillment operations provider, third party call center and Web hosting provider, delivery companies like UPS and the United States Postal Service, and credit card processing companies such as Paymentech and Cybersource to service our customers' needs. To the extent that there is a slowdown in mail service or package delivery services, whether as a result of labor difficulties, terrorist activity or otherwise, our cash flow and results of operations would be negatively impacted during such slowdown, and the results of such slowdown could have a long-term negative effect on our reputation with our customers. The failure of our fulfillment operations provider, third party call center, credit card processors or Web hosting provider to properly perform their services for us could cause similar effects. Our business is also generally dependent upon our ability to obtain the services of other persons and entities necessary for the development and maintenance of our business. If we fail to obtain the services of any such person or entities upon which we are dependent in satisfactory terms, or we are unable to replace such relationship, we would have to expend additional resources to develop such capabilities ourselves, which could have a material adverse impact on our short-term cash flow and results of operations and our long-term prospects.

We Are In Competition With Companies Much Larger Than Ourselves. Electronic commerce generally and, in particular, the online retail apparel and fashion accessories market, is a new, dynamic, high-growth market and is rapidly changing and intensely competitive. Our competition for customers comes from a variety of sources including:

- . existing land-based, full price retailers, such as Neiman Marcus, Saks Fifth Avenue, Bergdorf Goodman, Nordstrom, The Gap, and Macy's that are using the Internet to expand their channels of distribution;
- . less established online companies, such as eLuxury and Yoox;

Edgar Filing: BLUEFLY INC - Form 10-K

- . internet sites such as Amazon.com, Overstock.com and ebay.com
- . traditional direct marketers, such as L.L. Bean, Lands' End and J. Crew; and
- . traditional off-price retail stores such as T.J. Maxx, Marshalls, Ross, Filene's Basement and Loehmanns, which may or may not use the Internet to grow their customer base.

We expect competition in our industry to intensify and believe that the list of our competitors will grow. Many of our competitors and potential competitors have longer operating histories, significantly greater resources, greater brand name recognition and more firmly established supply relationships. We believe that the principal competitive factors in our market include:

- . brand recognition;
- . merchandise selection;
- . price;
- . convenience;
- . customer service;
- . order delivery performance; and
- . site features.

There can be no assurance that we will be able to compete successfully against competitors and future competitors, and competitive pressures faced by us could force us to increase expenses and/or decrease our prices at some point in the future.

We Do Not Have Long Term Contracts With Our Vendors And Therefore The Availability Of Merchandise Is At Risk. We have few agreements controlling the long-term availability of merchandise or the continuation of particular pricing

9

practices. Our contracts with suppliers typically do not restrict such suppliers from selling products to other buyers. There can be no assurance that our current suppliers will continue to sell products to us on current terms or that we will be able to establish new or otherwise extend current supply relationships to ensure product acquisitions in a timely and efficient manner and on acceptable commercial terms. Our ability to develop and maintain relationships with reputable suppliers and obtain high quality merchandise is critical to our success. If we are unable to develop and maintain relationships with suppliers that would allow us to obtain a sufficient amount and variety of quality merchandise on acceptable commercial terms, our ability to satisfy our customer's needs, and therefore our long-term growth prospects, would be materially adversely affected. See "Risk Factors - Brand Owners Could Establish Procedures to Limit Our Ability to Purchase Products Indirectly."

We Need To Further Establish Brand Name Recognition. We believe that further establishing, maintaining and enhancing our brand is a critical aspect of our efforts to attract and expand our online traffic. The number of Internet sites that offer competing services, many of which already have well established brands in online services or the retail apparel industry generally, increases the importance of establishing and maintaining brand name recognition. Promotion

Edgar Filing: BLUEFLY INC - Form 10-K

of Bluefly.com will depend largely on our success in providing a high quality online experience supported by a high level of customer service, which cannot be assured. In addition, to attract and retain online users, and to promote and maintain Bluefly.com in response to competitive pressures, we may find it necessary to increase substantially our advertising and marketing expenditures. If we are unable to provide high quality online services or customer support, or otherwise fail to promote and maintain Bluefly.com, or if we incur excessive expenses in an attempt to promote and maintain Bluefly.com, our long-term growth prospects, would be materially adversely affected.

There Can Be No Assurance That Our Technology Systems Will Be Able To Handle Increased Traffic; Implementation Of Changes To Web Site. A key element of our strategy is to generate a high volume of traffic on, and use of, Bluefly.com. Accordingly, the satisfactory performance, reliability and availability of Bluefly.com, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain customers, as well as maintain adequate customer service levels. Our revenues will depend on the number of visitors who shop on Bluefly.com and the volume of orders we can handle. Unavailability of our Web site or reduced order fulfillment performance would reduce the volume of goods sold and could also adversely affect consumer perception of our brand name. We may experience periodic system interruptions from time to time. If there is a substantial increase in the volume of traffic on Bluefly.com or the number of orders placed by customers, we will be required to expand and upgrade further our technology, transaction processing systems and network infrastructure. There can be no assurance that we will be able to accurately project the rate or timing of increases, if any, in the use of Bluefly.com or expand and upgrade our systems and infrastructure to accommodate such increases on a timely basis. In order to remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of Bluefly.com, which is particularly challenging given the rapid rate at which new technologies, customer preferences and expectations and industry standards and practices are evolving in the online commerce industry. Accordingly, we redesign and enhance various functions on our Web site on a regular basis, and we may experience instability and performance issues as a result of these changes. In addition, during the first half of 2005, we plan to move to a new co-location facility and in connection with the move will need to rebuild our systems with new hardware at the new co-location facility. This move may also result in short-term instability and performance issues, although in the long term we believe that it will provide us a more robust and stable environment.

We May Be Subject To Higher Return Rates. We recognize that purchases of apparel and fashion accessories over the Internet may be subject to higher return rates than traditional store bought merchandise. We have established a liberal return policy in order to accommodate our customers and overcome any hesitancy they may have with shopping via the Internet. If return rates are higher than expected, our business, prospects, financial condition, cash flows and results of operations could be materially adversely affected.

Our Success Is Largely Dependent Upon Our Executive Personnel. We believe our success will depend to a significant extent on the efforts and abilities of our executive personnel. In particular, we rely upon their strategic guidance, their relationships and credibility in the vendor and financial communities and their ability to recruit key operating personnel. The loss of the services of any of our executive officers could have a material adverse effect on our credibility in the vendor communities and our ability to recruit new key operating personnel.

Our Success Is Dependent Upon Our Ability To Attract New Key Personnel. Our operations will also depend to a great extent on our ability to attract new key personnel with relevant experience and retain existing key personnel in the future. The

market for qualified personnel is extremely competitive. Our failure to attract additional qualified employees could have a material adverse effect on our prospects for long-term growth.

There Are Inherent Risks Involved In Expanding Our Operations. We may choose to expand our operations by developing new Web sites, promoting new or complementary products or sales formats, expanding the breadth and depth of products and services offered, expanding our market presence through relationships with third parties, adopting non-Internet based channels for distributing our products, or consummating acquisitions or investments. Expansion of our operations in this manner would require significant additional expenses and development, operations and editorial resources and would strain our management, financial and operational resources. For example, we have historically expended significant internal resources in connection with the redesign of our Web site and the implementation of our online strategic alliances. Moreover, in the event that we expand upon our efforts to open brick-and-mortar outlet stores, we will be required to devote significant internal resources and capital to such efforts. There can be no assurance that we would be able to expand our efforts and operations in a cost-effective or timely manner or that any such efforts would increase overall market acceptance. Furthermore, any new business or Web site that is not favorably received by consumer or trade customers could damage our reputation.

We May Be Liable For Infringing The Intellectual Property Rights Of Others. Third parties may assert infringement claims against us. From time to time in the ordinary course of business we have been, and we expect to continue to be, subject to claims alleging infringement of the trademarks and other intellectual property rights of third parties. These claims and any resulting litigation, if it occurs, could subject us to significant liability for damages. In addition, even if we prevail, litigation could be time-consuming and expensive and could result in the diversion of our time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims.

We May Be Liable for Product Liability Claims. We sell products manufactured by third parties, some of which may be defective. If any product that we sell were to cause physical injury or injury to property, the injured party or parties could bring claims against us as the retailer of the product. Our insurance coverage may not be adequate to cover every claim that could be asserted. If a successful claim were brought against the Company in excess of our insurance coverage, it could have a material adverse effect on our cash flow and on our reputation with customers. Unsuccessful claims could result in the expenditure of funds and management time and could have a negative impact on our business.

We Cannot Guarantee The Protection Of Our Intellectual Property. Our intellectual property is critical to our success, and we rely on trademark, copyright, domain names and trade secret protection to protect our proprietary rights. Third parties may infringe or misappropriate our trademarks or other proprietary rights, which could have a material adverse effect on our business, prospects, results of operations or financial condition. While we enter into confidentiality agreements with our employees, consultants and strategic partners and generally control access to and distribution of our proprietary information, the steps we have taken to protect our proprietary rights may not prevent misappropriation. We are pursuing registration of various trademarks, service marks and domain names in the United States and abroad. Effective trademark, copyright and trade secret protection may not be available in every country, and there can be no assurance that the United States or foreign jurisdictions will afford us any protection for our intellectual property. There

Edgar Filing: BLUEFLY INC - Form 10-K

also can be no assurance that any of our intellectual property rights will not be challenged, invalidated or circumvented. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries is uncertain and still evolving. Moreover, even to the extent that we are successful in defending our rights, we could incur substantial costs in doing so.

Our Business Could Be Harmed By Consumers' Concerns About The Security Of Transactions Over The Internet. Concerns over the security of transactions conducted on the Internet and commercial online services, the increase in identity theft and the privacy of users may also inhibit the growth of the Internet and commercial online services, especially as a means of conducting commercial transactions. Moreover, although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches could have a material adverse effect on our business, prospects, financial condition and results of operations.

We Face Legal Uncertainties Relating To The Internet In General And To Our Industry In Particular And May Become Subject To Costly Government Regulation. We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to

11

online commerce. However, it is possible that laws and regulations may be adopted that would apply to the Internet and other online services. Furthermore, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on those companies conducting business online. The adoption of any additional laws or regulations may increase our cost of doing business and/or decrease the demand for our products and services and increase our cost of doing business.

The applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. Any such new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and online commerce could also increase our cost of doing business. In addition, if we were alleged to have violated federal, state or foreign, civil or criminal law, we could face material liability and damage to our reputation and, even if we successfully defend any such claim, we incur significant costs in connection with such defense.

We Face Uncertainties Relating To Sales And Other Taxes. We are not currently required to pay sales or other similar taxes in respect of shipments of goods into states other than Virginia, Ohio, New Jersey and New York. However, one or more states may seek to impose sales tax collection obligations on out-of-state companies such as our company that engage in online commerce. In addition, any new operation in states outside Virginia, Ohio, New Jersey and New York could subject shipments into such states to state sales taxes under current or future laws. A successful assertion by one or more states or any foreign country that the sale of merchandise by us is subject to sales or other taxes, could subject us to material liabilities and, to the extent that we pass such costs on to our customers, could decrease our sales.

Change Of Control Covenant And Liquidation Preference Of Preferred Stock. We have agreed with Soros, that for so long as any shares of their Preferred Stock

Edgar Filing: BLUEFLY INC - Form 10-K

are outstanding, we will not take any action to approve or otherwise facilitate any merger, consolidation or change of control, unless provisions have been made for the holders of such Preferred Stock to receive from the acquirer an amount in cash equal to the respective aggregate liquidation preferences of such Preferred Stock. The aggregate liquidation preference of the Preferred Stock is equal to the greater of (i) approximately \$49,100,000 (plus any accrued and unpaid dividends) and (ii) the amount that the holders of shares of Preferred Stock would receive if they were to convert such shares of Common Stock immediately prior to liquidation.

The Holders Of Our Common Stock May Be Adversely Affected By The Rights Of Holders Of Preferred Stock That May Be Issued In The Future. Our certificate of incorporation and by-laws, as amended, contain certain provisions that may delay, defer or prevent a takeover. Our Board of Directors has the authority to issue up to 15,486,250 additional shares of preferred stock, and to determine the price, rights, preferences and restrictions, including voting rights, of those shares, without any further vote or action by the stockholders. Accordingly, our Board of Directors is empowered, without approval of the holders of Common Stock, to issue preferred stock, for any reason and at any time, with such rates of dividends, redemption provisions, liquidation preferences, voting rights, conversion privileges and other characteristics as they may deem necessary. The rights of holders of Common Stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future.

We Rely On The Effectiveness Of Our Internal Controls. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and assess on an on-going basis the design and operating effectiveness of our internal control structure and procedures for financial reporting. Our independent registered accounting firm will be required to audit both the design and operating effectiveness of our internal controls and management's assessment of the design and the effectiveness of its internal controls for the year ended December 31, 2005. It is possible that, in preparation for this audit, we could discover certain deficiencies in the design and/or operation of our internal controls that could adversely affect our ability to record, process, summarize and report financial data. We have invested and will continue to invest significant resources in this process. Because management's assessment of internal controls has not been required to be reported in the past, we are uncertain as to what impact a conclusion that deficiencies exist in our internal controls over financial reporting would have on the trading price of our common stock.

Forward-Looking Statements and Associated Risks. This Annual Report contains "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. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "project," "will be," "will continue," "will likely result," or words or phrases of similar meaning. Forward-looking statements involve risks and

uncertainties that may cause actual results to differ materially from the forward-looking statements ("Cautionary Statements"). The risks and uncertainties include, but are not limited to those matters addressed herein under "Risk Factors." All subsequent written and oral forward-looking statements attributable to the Company or persons acting on the Company's behalf are expressly qualified in their entirety by the Cautionary Statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which

Edgar Filing: BLUEFLY INC - Form 10-K

speak only as of their dates. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 2. PROPERTIES

We lease approximately 26,000 square feet of office space in New York City. The property is in good operating condition. The lease expires in 2010. Our total lease expense for the current office space during 2004 was approximately \$442,000.

ITEM 3. LEGAL PROCEEDINGS

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

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET INFORMATION

The Company's common stock, par value \$.01 per share ("Common Stock"), is quoted on The Nasdaq SmallCap Market and the Boston Stock Exchange. The following table sets forth the high and low bid prices for the Common Stock for the periods indicated, as reported by the Nasdaq SmallCap Market:

FISCAL 2004	HIGH	LOW
-----	-----	-----
First Quarter	\$ 4.93	\$ 3.07
Second Quarter	\$ 3.44	\$ 1.92
Third Quarter	\$ 2.30	\$ 1.40
Fourth Quarter	\$ 3.56	\$ 1.75
FISCAL 2003	HIGH	LOW
-----	-----	-----
First Quarter	\$ 1.69	\$ 0.67
Second Quarter	\$ 1.60	\$ 0.72
Third Quarter	\$ 1.80	\$ 0.76
Fourth Quarter	\$ 5.96	\$ 1.20

HOLDERS

As of February 18, 2005, there were approximately 109 holders of record of the Common Stock. We believe that there were more than 5,000 beneficial holders of the Common Stock as of such date.

DIVIDENDS

We have never declared or paid cash dividends on our Common Stock. We currently intend to retain any future earnings to finance future growth and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

EQUITY COMPENSATION PLAN INFORMATION (AS OF DECEMBER 31, 2004)

Edgar Filing: BLUEFLY INC - Form 10-K

PLAN CATEGORY	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (a)	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (b)	NUMBER REMAIN FUTURE EQUITY (EXCLU REFLEC (c)
Equity compensation plans approved by security holders	8,911,789	\$ 2.35	
Equity compensation plans not approved by security holders	901,590	\$ 1.60	
Total	9,813,379	\$ 2.28	

The following is a summary of the material provisions of the Bluefly, Inc. 2000 Plan Stock Option Plan (the "2000 Plan"), our only equity compensation plan that has not been approved by our stockholders.

Eligibility. Key employees of the Company who are not officers or directors of the Company and its affiliates and consultants to the Company are eligible to be granted options.

Administration of the 2000 Plan. The Option Plan/Compensation Committee administers the 2000 Plan. The Option Plan/Compensation Committee has the full power and authority, subject to the provisions of the 2000 Plan, to designate participants, grant options and determine the terms of all options. The 2000 Plan provides that no participant may be granted options to purchase more than 1,000,000 shares of Common Stock in a fiscal year. The Option Plan/Compensation Committee is required to make adjustments with respect to options granted under the 2000 Plan in order to prevent dilution or expansion of the rights of any holder. The 2000 Plan requires that the Option Plan/Compensation Committee be composed of at least two directors.

Amendment. The 2000 Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Board of Directors, but no amendment without the approval of our stockholders shall be made if stockholder approval would be required under any law or rule of any governmental authority, stock exchange or other self-regulatory organization to which we are subject. Neither the amendment, suspension or termination of the 2000 Plan shall, without the consent of the holder of an option under the 2000 Plan, alter or impair any rights or obligations under any option theretofore granted.

Options Issued Under 2000 Plan. The Option Plan/Compensation Committee determines the term and exercise price of each option under the 2000 Plan and the time or times at which such option may be exercised in whole or in part, and the method or methods by which, and the form or forms in which, payment of the exercise price may be paid.

Upon the exercise of an option under the 2000 Plan, the option holder shall pay us the exercise price plus the amount of the required federal and state withholding taxes, if any. The 2000 Plan also allows participants to elect to have shares withheld upon exercise for the payment of withholding taxes.

The unexercised portion of any option granted to a key employee under the 2000 Plan generally will be terminated (i) 30 days after the date on which the

Edgar Filing: BLUEFLY INC - Form 10-K

optionee's employment is terminated for any reason other than (a) Cause (as defined in the 2000 Plan), (b) retirement or mental or physical disability, or (c) death; (ii) immediately upon the termination of the optionee's employment for Cause; (iii) three months after the date on which the optionee's employment is terminated by reason of retirement or mental or physical disability; or (iv) (A) 12 months after the date on which the optionee's employment is terminated by reason of his death or (B) three months after the date on which the optionee shall die if such death occurs during the three-month period following the termination of the optionee's employment by reason of retirement or mental or physical

14

disability. The Option Plan/Compensation Committee has in the past, and may in the future, extend the period of time during which an optionee may exercise options following the termination of his or her employment.

Under the 2000 Plan, an option generally may not be transferred by the optionee other than by will or by the laws of descent and distribution. During the lifetime of an optionee, an option under the 2000 Plan may be exercised only by the optionee or, in certain instances, by the optionee's guardian or legal representative, if any.

15

ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical results are not necessarily indicative of future results. All data is in thousands, except share data:

STATEMENT OF OPERATIONS DATA:

	Year Ended December		
	2004	2003	2002
Net sales	\$ 43,799	\$ 37,928	\$ 30,606
Cost of sales	27,393	26,603	20,571
Gross profit	16,406	11,325	10,035
Selling, marketing and fulfillment expenses	13,996	12,061	11,547
General and administrative expenses	6,333	5,239	4,686
Total operating expenses	20,329	17,300	16,233
Operating loss	(3,923)	(5,975)	(6,198)
Interest (expense)/other income	132	(394)	(281)
Net loss	(3,791)	(6,369)	(6,479)
Basic and diluted loss per share:	\$ (0.55)	\$ (0.88)	\$ (2.44)

Basic and diluted weighted average number of common shares outstanding available to common

Edgar Filing: BLUEFLY INC - Form 10-K

stockholders 14,586,752 11,171,018 9,927,027

BALANCE SHEET DATA:

	As of December 31,		
	2004	2003	2002
Cash and cash equivalents	\$ 7,938/(1)/	\$ 7,721	\$ 1,749
Inventories, net	12,958	11,340	10,868
Other current assets	2,559	1,863	1,159
Total assets	25,541	22,998	16,595
Current liabilities	9,413	8,459	7,072
Short-term convertible notes payable, net		-	-
Long term liabilities	4,739	4,260	2,439
Redeemable preferred stock	-	-	-
Shareholders' equity (deficit)	11,389	10,279	7,084

/(1)/ Includes restricted cash of \$1,253

16

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections of future events. However, our actual results could differ materially from those discussed herein as a result of the risks that we face, including but not limited to those risks stated in "Risk Factors," or faulty assumptions on our part. In addition, the following discussion should be read in conjunction with the audited consolidated financial statements and the related notes thereto included elsewhere in this report.

OVERVIEW

We are a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discounts up to 75% off retail value. The Bluefly.com Web site was launched in September 1998.

Our gross profit increased by approximately 45% to \$16,406,000 in 2004, from \$11,325,000 in 2003. This growth was driven by increases in both net sales and gross margins, and allowed us to decrease our net loss by approximately 40%, to \$3,791,000 in 2004, from \$6,369,000 in 2003.

Our net sales increased approximately 15% to \$43,799,000 for the year ended December 31, 2004 from \$37,928,000 for the year ended December 31, 2003. For the first three quarters of 2004, our net sales increased by approximately 35%, 27% and 6%, respectively, as compared to the same periods in 2003. For the entire fourth quarter of 2004, our net sales increased by approximately 4% to \$14,515,000 from \$13,993,000 in the fourth quarter of 2003. Our net sales actually decreased in October 2004, but rebounded strongly in November and December 2004, which resulted in net sales growth for the quarter.

Net sales attributable to the Company's Web site increased by approximately 7%

Edgar Filing: BLUEFLY INC - Form 10-K

during the quarter, to \$14,230,000 in the fourth quarter of 2004 from \$13,356,000 in the fourth quarter of 2003, while net sales attributable to the Company's temporary Manhattan store, which opened in late November, decreased to approximately \$251,000 compared to \$465,000 for the same period in 2003.

Our gross margin increased to 37.5% from 29.9% in 2003, 32.8% in 2002 and 30.5% in 2001. The increase in 2004 was driven by a merchandising strategy that focused on negotiating better prices with vendors as well as selling more in-season product which has more value to our customer and therefore demands higher margins. In 2003 the lower margins resulted from our decision to turn more of our out-of-season merchandise, as well as inventory items that we were particularly deep in, into cash that could be used to purchase new inventory, rather than holding the inventory for the next season.

For the fourth quarter of 2004, we had net income of \$7,000 as compared to net income of \$111,000 in the fourth quarter of 2003. The decrease in net income was partly the result of the Company's temporary Manhattan store, which contributed significantly to our profitability during the fourth quarter of 2003, but did not contribute to our profit in any material respect during the fourth quarter of 2004. We believe that the store did not perform as well financially in 2004 as it did in 2003 because we tested pricing and branding strategies that were more in line with those of our Web site. While the performance of the store was not as strong during 2004 as it was during 2003, we believe that the relatively small investment provided us with valuable experience that we can use in the future in an effort to build a store strategy that is in line with our brand strategy and offers stronger financial performance.

Our reserve for returns and credit card chargebacks decreased slightly to 36.6% in 2004 from 37.1% in 2003 and it had been 35.5% in 2002. We believe that the slight improvement in the return rate is attributable to more detailed analysis on customer purchase and return habits as well as initiatives related to the way we photograph and describe our product and improved buying by the merchant team. The increase in return rates in prior years was primarily driven by shifts in our merchandise mix towards products that generate higher return rates, but also higher gross margins and average order sizes. While we are testing initiatives to reduce our return rates, we believe that the overall shift in merchandise mix has been beneficial to the overall gross profit realized per order. Accordingly, we do not expect return rates to decrease to 2002 levels in the near term.

At December 31, 2004, we had an accumulated deficit of \$96,127,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site, building our infrastructure and non-cash charges in connection with automatic decreases in the conversion price of our Preferred Stock. In order to expand our business,

17

we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore expect to continue to incur substantial operating losses for the foreseeable future. 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

Edgar Filing: BLUEFLY INC - Form 10-K

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, recoverability of inventories, useful lives of property and equipment and the realization of deferred tax assets. 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 or loss 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 deemed necessary. In the event

Edgar Filing: BLUEFLY INC - Form 10-K

that we were to determine that we would be able to realize our deferred tax assets, an adjustment to the deferred tax valuation allowance would increase income in the period such determination is made.

RESULTS OF OPERATIONS

The following table sets forth our statement of operations data for the years ended December 31st. All data is in thousands except as indicated below:

	2004		2003	
	AS A % OF	AS A % OF	AS A % OF	AS A % OF
	NET SALES	NET SALES	NET SALES	NET SALES
	-----	-----	-----	-----
Net sales	\$ 43,799	100.0%	\$ 37,928	100.0%
Cost of sales	27,393	62.5%	26,603	70.1%
	-----		-----	
Gross profit	16,406	37.5%	11,325	29.9%
Selling, marketing and fulfillment expenses	13,996	32.0%	12,061	31.8%
General and administrative expenses	6,333	14.4%	5,239	13.8%
	-----		-----	
Total operating expenses	20,329	46.4%	17,300	45.7%
Operating loss	(3,923)	(8.9)%	(5,975)	(15.8)%
Interest (expense) other income	132	0.3%	(394)	(1.0)%
	-----		-----	
Net loss	\$ (3,791)	(8.6)%	\$ (6,369)	(16.8)%

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 years ended December 31st, as indicated below:

	2004	2003
	-----	-----
Average Order Size (including shipping & handling)	\$ 188.51	\$ 177.50
Average Order Size Per New Customer (including shipping & handling)	\$ 159.38	\$ 150.00
Average Order Size Per Repeat Customer (including shipping & handling)	\$ 205.10	\$ 187.50
Total Customers	640,125	512,000
Customers Added during the Year	127,177	124,000
Revenue from Repeat Customers as a % of total Revenue	70%	70%
Customer Acquisition Costs	\$ 11.41	\$ 11.41

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

FOR THE YEAR ENDED DECEMBER 31, 2004 COMPARED TO THE YEAR ENDED DECEMBER 31, 2003

Edgar Filing: BLUEFLY INC - Form 10-K

Net sales: Gross sales for the year ended December 31, 2004 increased by approximately 15% to \$69,032,000, from \$60,279,000 for the year ended December 31, 2003. The provision for returns and credit card chargebacks and other discounts was approximately 37% for both 2004 and 2003, resulting in a provision of \$25,233,000 for the year ended December 31, 2004 and \$22,351,000 for the year ended December 31, 2003.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2004 were \$43,799,000. This represents an increase of approximately 15% compared to the year ended

19

December 31, 2003, in which net sales totaled \$37,928,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 8% higher than the full year 2003) and a slight increase in the number of new customers acquired (approximately 2% higher than the full year 2003). Shipping and handling revenue (which is included in net sales) increased by 14% to \$3,353,000 for the year ended December 31, 2004, from \$2,939,000 for the year ended December 31, 2003.

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 year ended December 31, 2004 totaled \$27,393,000, resulting in gross margin of approximately 38%. Cost of sales for the year ended December 31, 2003 totaled \$26,603,000, resulting in gross margin of 30%. The increase in gross margin was driven by a merchandising strategy that focused on negotiating better prices with vendors as well as selling more in-season product, which has more value to our customer and therefore demands higher margins. The gross margin in 2003 was impacted negatively by our decision to reduce our product margin during the first three quarters of 2003 on certain merchandise in an effort to reduce prior season inventory levels.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by 45%, to \$16,406,000 for the year ended December 31, 2004, from \$11,325,000 for the year ended December 31, 2003.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 16% for the year 2004 compared to the year ended 2003. As a percentage of net sales, our selling, marketing and fulfillment expenses remained relatively unchanged at approximately 32% for both 2004 and 2003. The selling, marketing and fulfillment expenses were comprised of the following:

	YEAR ENDED DECEMBER 31, 2004	YEAR ENDED DECEMBER 31, 2003	PERCENTAGE DIFFERENCE INCREASE (DECREASE)
Marketing	\$ 2,213,000	\$ 1,898,000	16.6%
Operating	5,848,000	5,223,000	12.0%
Technology	4,086,000	3,420,000	19.5%
E-Commerce	1,849,000	1,520,000	21.6%
	-----	-----	
	\$ 13,996,000	\$ 12,061,000	16.0%

Marketing expenses include expenses related to online and print advertising, direct mail campaigns as well as staff related costs. The increase in marketing expenses of approximately 17% was primarily driven by the donation of the net proceeds from the sale of "hope." collection products to St. Jude Children's Research Hospital ("St. Jude"). Pursuant to a charitable program with St. Jude, we were the exclusive retailer of the "hope." t-shirt and agreed to donate the

Edgar Filing: BLUEFLY INC - Form 10-K

net proceeds (i.e., the revenue less the cost of goods sold and the costs of processing and filling the orders) from the sale of all "hope." collection products on our Web site to St. Jude. For the year ended December 31, 2004, approximately \$141,000 was donated and has been recorded as a marketing expense in our financial statements. A portion of the increase also resulted from increased consulting expenses, which were offset slightly by a decrease in staff related expenses. In the event that we attempt to accelerate revenue growth, it may be necessary to utilize less cost efficient methods of customer acquisition, and accordingly there can be no assurance that customer acquisition costs will not increase further in the future.

Operating expenses include all costs related to inventory management, fulfillment, customer service, credit card processing and during the fourth quarters, the costs associated with the Company's temporary Manhattan store. Operating expenses increased in 2004 by approximately 12% compared to 2003 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 the overhead costs associated with the store.

Technology expenses consist primarily of Web site hosting and staff related costs. For the year ended December 31, 2004, technology expenses increased by approximately 20% compared to the year ended December 31, 2003. This increase was related to an increase in headcount, overall web hosting costs and consulting costs and was slightly offset by a decrease in depreciation expense. The department employed an average of 18 people per month in 2004 compared to 12 people per month in 2003.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web site design. For the year ended December 31, 2004, this amount increased by approximately 22% as compared to the year ended December 31, 2003. This increase is to the result of an increase in staff related costs, temporary help and the purchase of licenses for new search functionality and Web site analytics.

20

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 year ended December 31, 2004 increased by approximately 21% to \$6,333,000 as compared to \$5,239,000 for the year ended December 31, 2003. As a percentage of net sales, general and administrative expenses increased to 14.4% in 2004 from 13.8% in 2003. The increase in general and administrative expenses was the result of increased salary and benefit expenses of approximately 45% (including \$325,000 of expenses incurred in connection with the Separation Agreement that we entered into with our former CEO) as well as an increase in public company fees. These increases were slightly offset by a reduction in consulting and professional fees. Due to the cost of compliance of Sarbanes-Oxley we anticipate that professional and public company fees will continue to increase in 2005.

Loss from operations: Operating loss decreased by approximately 34% in 2004, to \$3,923,000 from \$5,975,000 in 2003 as a result of the increase in gross profit.

Interest expense and Interest and other income, net: Interest and other income for year ended December 31, 2004 increased to \$847,000 from \$38,000 for the year ended December 31, 2003. The increase resulted from \$564,000 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 as described in Note 3 to our financial statements), the \$169,000 realized in connection with the judgment we received in the Breider Moore litigation and an

Edgar Filing: BLUEFLY INC - Form 10-K

increase in interest income earned on our cash balance.

Interest expense for the year ended 2004 totaled \$715,000, and related primarily to fees paid in connection with the Loan Facility and interest expense on Convertible Notes held by Soros. Interest expense for the year ended December 31, 2003 totaled \$432,000, and related to fees paid in connection with our Loan Facility as well as amortization of warrants issued in connection with the January 2003 Financing.

FOR THE YEAR ENDED DECEMBER 31, 2003 COMPARED TO THE YEAR ENDED DECEMBER 31, 2002

Net sales: Gross sales for the year ended December 31, 2003 increased by approximately 27% to \$60,279,000, from \$47,491,000 for the year ended December 31, 2002. For the year ended December 31, 2003, we recorded a provision for returns and credit card chargebacks and other discounts of \$22,351,000, or approximately 37% of gross sales. For the year ended December 31, 2002, the provision for returns and credit card chargebacks and other discounts was \$16,885,000, or approximately 36% of gross sales. The increase in this provision as a percentage of gross sales was related primarily to an increase in the return rate. We believe that the increase in return rate was partly the result of a shift in our merchandise mix towards certain product categories that historically have generated higher return rates, but also higher gross margins and average order size.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2003 were \$37,928,000. This represents an increase of approximately 24% compared to the year ended December 31, 2002, in which net sales totaled \$30,606,000. The growth in net sales was largely driven by the increase in the numbers of new customers acquired (approximately 23% higher than the full year 2002) and the increase in gross average order size (approximately 5% higher than the full year 2002). In addition, our shipping and handling revenue increased as we raised our standard shipping rate from \$5.95 per order to \$7.95 per order in the first quarter of 2003. For the year ended December 31, 2003, revenue from shipping and handling (which is included in net sales) increased by 44% to \$2,939,000 from \$2,048,000 for the year ended December 31, 2002.

Cost of sales: Cost of sales for the year ended December 31, 2003 totaled \$26,603,000, resulting in gross margin of approximately 30%. Cost of sales for the year ended December 30, 2002 totaled \$20,571,000, resulting in gross margin of 33%. The decrease in gross margin resulted primarily from our decision to reduce our product margin during the first three quarters of 2003 on certain merchandise in an effort to reduce prior season inventory levels.

Gross Profit: Gross profit increased by 13%, to \$11,325,000 for the year ended December 31, 2003, compared to \$10,035,000 for the year ended December 31, 2002. The increase in gross profit was the result of net sales growth, partially offset by the decrease in gross margin.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 5% for the year 2003 compared to the year ended 2002. As a percentage of net sales, our selling, marketing and fulfillment expenses

decreased to 32% in 2003 from approximately 37.7% in 2002. The decrease resulted primarily from refinements to our marketing strategy that allowed us to better target potential new customers and convert repeat customers, as well as the cost savings we derived from our move to a new web hosting facility. Selling,

Edgar Filing: BLUEFLY INC - Form 10-K

marketing and fulfillment expenses were comprised of the following:

	YEAR ENDED DECEMBER 31, 2003	YEAR ENDED DECEMBER 31, 2002	PERCENTAGE DIFFERENCE INCREASE (DECREASE)
	-----	-----	-----
Marketing	\$ 1,898,000	\$ 2,275,000	(16.6)%
Operating	5,223,000	4,533,000	15.2%
Technology	3,420,000	3,552,000	(3.7)%
E-Commerce	1,520,000	1,187,000	28.1%
	-----	-----	
	\$ 12,061,000	\$ 11,547,000	4.5%

Marketing expenses include expenses related to online and print advertising, direct mail campaigns as well as staff related costs. The decrease in marketing expenses of approximately 17% was largely related to a shift in our customer acquisition strategy. We reduced our advertising expenditures and focused more on email, affiliate programs and other performance based programs. Primarily as a result of this shift, we were able to decrease our customer acquisition costs for the year ended December 31, 2003 by approximately 40% to \$10.22 per new customer from \$17.04 per new customer for the year ended December 31, 2002.

Operating expenses include all costs related to inventory management, fulfillment, customer service, credit card processing and during the fourth quarter of 2003, the costs associated with the Company's temporary Manhattan store. Operating expenses increased in 2003 by approximately 15% compared to 2002 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees).

Technology expenses consist primarily of Web site hosting and staff related costs. For the year ended December 31, 2003, technology expenses decreased by approximately 4% compared to the year ended December 31, 2002. This decrease was related to a decrease in overall web hosting costs offset by accelerated depreciation of equipment acquired under a capital lease due to a change in the estimated useful life, along with increased amortization expense incurred as a result of capitalized costs incurred in connection with the upgraded version of the Web Site. Depreciation and amortization for the year ended December 31, 2003 represented approximately 40% of the total technology expense, while depreciation and amortization for the year ended December 31, 2002 represented approximately 17% of the total technology expense. These amounts were partially offset by a reduction of approximately 61% in our Web Site hosting costs in connection with our move to a new web hosting facility.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web Site design. For the year ended December 31, 2003, this amount increased by approximately 28% as compared to the year ended December 31, 2002, primarily due to the creation of an Online Retail Group within the E-Commerce department. The department employed an average of 17 employees per month in 2003, compared to an average of 13 per month in 2002. The Online Retail Group is, among other things, responsible for leveraging the Web Site technology to improve the on-site customer experience. In September 2003, we launched a redesigned Web Site. The redesigned Web Site provided a new look and, we believe, more intuitive navigation. The costs of the new site were primarily included in E-Commerce and expensed as incurred.

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 year ended December 31, 2003 increased by approximately 12% to \$5,239,000 as compared to \$4,686,000 for the year ended December 31, 2002. As a percentage of net sales, general and administrative expenses decreased to 13.8% in 2003 from 15.3% in 2002. The increase in general and administrative expenses was the result of

Edgar Filing: BLUEFLY INC - Form 10-K

increased salary and benefit expenses of approximately 7% as well as an increase in professional fees of 50%.

Loss from operations: Operating loss decreased by approximately 4% in 2003, to \$5,975,000 from \$6,198,000 in 2002 as a result of the increase in sales and gross margin dollars and decreases in selling, marketing and fulfillment expenses and general and administrative expenses as a percentage of net sales.

Interest expense and other income, net: Interest expense for the year ended December 31, 2003 totaled \$432,000, and related to fees paid in connection with our Loan Facility, amortization of warrants issued in connection with the January 2003

22

Financing, and interest on the notes issued in connection with the July 2003 Financing. For the year ended December 31, 2002, interest expense totaled \$349,000, and related primarily to fees paid in connection with the Loan Facility.

Interest income for the year ended December 31, 2003 decreased to \$38,000 from \$68,000 for the year ended December 31, 2002. The decrease is related to the decrease in our cash balance as interest income primarily represents interest earned on our cash balance.

LIQUIDITY AND CAPITAL RESOURCES

GENERAL

At December 31, 2004, we had approximately \$6.7 million of liquid assets, entirely in the form of cash and cash equivalents, and working capital of approximately \$12.8 million (both amounts exclude the \$1.25 million of restricted cash). In addition, as of December 31, 2004, we had approximately \$2.3 million of borrowings committed under the Loan Facility, leaving approximately \$1.2 million of availability. At December 31, 2003, we had approximately \$2.3 million of borrowings committed, leaving \$2.1 million of availability.

In February 2005, we extended the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended for one year, from May 1, 2005 to May 1, 2006. Also in February 2005, we renewed the Loan Facility with Rosenthal for an additional year, from March 30, 2005 to March 30, 2006.

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 Loan Facility is based upon our inventory levels and is dependent, among other things, on the Company having at least \$7.0 million of tangible net worth and \$6.0 million of working capital and cash balances of at least \$750,000 (exclusive of the \$1.25 million cash collateral pledged to Rosenthal to secure our obligations under the Loan Facility). In addition, both availability under the Loan Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Rosenthal to provide credit support under the Loan Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and

Edgar Filing: BLUEFLY INC - Form 10-K

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.

We anticipate that our existing resources and working capital should be sufficient to satisfy our cash requirements through the end of fiscal 2005. Of course, there can be no assurance that such expectations will prove to be correct. If we do not achieve our operating plan, and additional financing is not available, future operations may need to be modified, scaled back or discontinued. Moreover, we may seek additional debt and/or equity financing in order to maximize the growth of our business and accelerate customer acquisition. There can be no assurance that any additional financing or other sources of capital will be available to us upon acceptable terms, or at all.

LOAN FACILITY

Pursuant to the Loan Facility, Rosenthal provides us with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to our suppliers. The Rosenthal Financing Agreement was amended in April 2004 to: (i) extend the term until March 30, 2005 (later extended further, as described below); (ii) substitute \$1.25 million of cash collateral pledged by the Company for the \$2.0 million standby letter of credit previously provided by Soros as collateral security for the Company's obligations under the Loan Facility; (iii) decrease the maximum amount available under the Loan Facility from \$4.5 million to \$4.0 million; (iv) increase the tangible net worth requirement to \$7.0 million; (v) increase the working capital requirement to \$6.0 million; and (vi) increase the minimum cash balance that the Company is required to maintain to \$750,000 (exclusive of the \$1.25 million in cash collateral). Because we removed the requirement that Soros provide a standby letter of credit to secure the Loan Facility, we are no longer subject to an agreement with Soros that previously required us to issue additional warrants to Soros with an exercise price equal to 75% of

23

market price in the event that Rosenthal were to draw on Soros' letter of credit. In February 2005, the Rosenthal Financing Agreement was further extended to March 30, 2006. All other terms of the Rosenthal Financing Agreement remained the same.

Interest accrues monthly on the average daily amount outstanding under the Loan Facility during the preceding month at a per annum rate equal to the prime rate plus 1%. We pay an annual facility fee equal to 1.5% of the portion of the Loan Facility that is provided on the basis of our inventory level. This formula currently results in an annual facility fee of \$33,750. We also pay Rosenthal 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.

In consideration for the Loan Facility, among other things, we granted to Rosenthal a first priority lien on substantially all of our assets, including control of all of our cash accounts (including the \$1.25 million of cash collateral, which has been placed in a segregated, restricted account) upon an event of default and certain of our cash accounts in the event that the total amount of funded debt loaned to us under the Loan Facility exceeds 90% of the maximum amount available under the Loan Facility for more than 10 days.

Under the terms of the Loan Facility, Soros has the right to purchase all of our obligations from Rosenthal at any time during its term.

Edgar Filing: BLUEFLY INC - Form 10-K

COMMITMENTS AND LONG TERM OBLIGATIONS

As of December 31, 2004, we had the following commitments and long term obligations:

	2005	2006	2007	2008	THER
	-----	-----	-----	-----	-----
Marketing and Advertising	\$ 150,000	--	--	--	
Operating Leases	462,000	469,000	481,000	441,000	
Capital Leases	139,000	54,000	27,000	--	
Employment Contracts	1,219,000	1,030,000	324,000	--	
Notes payable to shareholders	--	4,000,000 *	--	--	
	-----	-----	-----	-----	-----
Grand total	\$ 1,970,000	\$ 5,553,000	\$ 832,000	\$ 441,000	\$

* Notes were reclassified to long term in February 2005, See "Recent Developments"

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.

In order to continue to expand our product offerings, we intend to expand our relationships with suppliers of end-of-season and excess name brand apparel and fashion accessories. We expect that our suppliers will continue to include designers and retail stores that sell excess inventory as well as third-party end-of-season apparel aggregators. To achieve our goal of offering a wide selection of top name brand designer clothing and fashion accessories, we may acquire certain goods on consignment and may explore leasing or partnering select departments with strategic partners and distributors,

RECENT ACCOUNTING PRONOUNCEMENTS

In March, 2004, the Emerging Issues Task Force issued EITF 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128". This statement provides additional guidance on the calculation and disclosure requirements for earnings per share. The FASB concluded in EITF 03-6 that companies with multiple classes of common stock or participating securities, as defined by SFAS No. 128, calculate and disclose earnings per share based on the two-class method. The adoption of this statement does not have an impact to the Company's financial statement presentation as the Company is currently in a loss position.

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

Edgar Filing: BLUEFLY INC - Form 10-K

additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R will be effective for 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 financial condition or cash flows but the non-cash charges associated therewith are expected to have a significant, adverse effect on our results of operations.

ITEM 7A. 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 8. FINANCIAL STATEMENTS

(a) Index to the Financial Statements

Report of Independent Registered Public Accounting Firm	F-1
Consolidated Balance Sheets as of December 31, 2004 and 2003	F-2
Consolidated Statements of Operations for the three years ended December 31, 2004, 2003 and 2002	F-3
Consolidated Statements of Changes in Shareholders' Equity for the three years ended December 31, 2004, 2003 and 2002	F-4
Consolidated Statements of Cash Flows for the three years ended December 31, 2004, 2003 and 2002	F-5
Notes to Consolidated Financial Statements	F-6
Schedule II - Valuation and Qualifying Accounts	S-1

25

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
of Bluefly, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Bluefly, Inc. and its subsidiary at December 31, 2004 and December 31, 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about

Edgar Filing: BLUEFLY INC - Form 10-K

whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

New York, New York
February 18, 2005

F-1

BLUEFLY, INC.
CONSOLIDATED BALANCE SHEETS
December 31, 2004 and 2003
(dollars rounded to the nearest thousand)

	2004
<hr style="border-top: 1px dashed black;"/>	
ASSETS	
Current assets	
Cash and cash equivalents	\$ 6,685,00
Restricted cash	1,253,00
Inventories, net	12,958,00
Accounts receivable, net of allowance for doubtful accounts	1,206,00
Prepaid expenses and other current assets	1,353,00
Total current assets	23,455,00
Property and equipment, net	1,933,00
Other assets	153,00
Total assets	\$ 25,541,00
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	\$ 4,190,00
Accrued expenses and other current liabilities	3,526,00
Deferred revenue	1,697,00
Notes payable to related party shareholders	
Total current liabilities	9,413,00
Notes payable to related party shareholders	4,000,00
Long-term interest payable to related party shareholders	658,00
Long-term obligations under capital lease	81,00
Total liabilities	14,152,00
Commitments and contingencies (Note 8)	
Shareholders' equity	
Series A Preferred Stock - \$.01 par value; 500,000 shares authorized, 460,000 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: \$9.2 million plus accrued dividends of \$5.0 million)	5,00

Edgar Filing: BLUEFLY INC - Form 10-K

Series B Preferred Stock - \$.01 par value; 9,000,000 shares authorized, 8,889,414 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: \$30 million plus accrued dividends of \$7.3 million)	89,00
Series C Preferred Stock - \$.01 par value; 3,500 shares authorized, 1,000 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: \$1 million plus accrued dividends of \$191,000)	
Series D Preferred Stock - \$.01 par value; 7,150 shares authorized, 7,136.548 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: \$7.1 million plus accrued dividends of \$1.6 million)	
Series E Preferred Stock - \$.01 par value; 1,000 shares authorized, issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: \$1.0 million plus accrued dividends of \$202,000)	
Common Stock - \$.01 par value; 92,000,000 shares authorized, 15,241,756 and 12,894,166 shares issued and outstanding as of December 31, 2004 and 2003, respectively	152,00
Additional paid-in capital	107,270,00
Accumulated deficit	(96,127,00

Total shareholders' equity	11,389,00

Total liabilities and shareholders' equity	\$ 25,541,00
	=====

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

F-2

BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2004, 2003 and 2002
(dollars rounded to the nearest thousand)

	2004	2003	
	-----	-----	-----
Net sales	\$ 43,799,000	\$ 37,928,000	\$
Cost of sales	27,393,000	26,603,000	
	-----	-----	-----
Gross profit	16,406,000	11,325,000	
Selling, marketing and fulfillment expenses	13,996,000	12,061,000	
General and administrative expenses	6,333,000	5,239,000	
	-----	-----	-----
Total operating expenses	20,329,000	17,300,000	
	-----	-----	-----
Operating loss	(3,923,000)	(5,975,000)	
Interest expense	(715,000)	(432,000)	
Interest income	114,000	38,000	
Other income (Note 6)	733,000	-	
	-----	-----	-----

Edgar Filing: BLUEFLY INC - Form 10-K

Net loss	(3,791,000)	(6,369,000)	
Preferred stock dividends	(4,275,000)	(3,225,000)	
Deemed dividend related to beneficial conversion feature on Series B and C Preferred Stock	-	(225,000)	
Net loss available to common shareholders	\$ (8,066,000)	\$ (9,819,000)	\$ ()
Basic and diluted loss per common share	\$ (0.55)	\$ (0.88)	\$ ()
Weighted average number of shares outstanding used in calculating basic and diluted loss per common share	14,586,752	11,171,018	

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

F-3

BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2004, 2003 and 2002
(Dollars rounded to the nearest thousand)

	SERIES A PREFERRED STOCK \$.01 PAR VALUE	
	NUMBER OF SHARES	AMOUNT
BALANCE AT JANUARY 1, 2002	500,000	\$ 5,000
Sale of common stock in connection with the Standby Commitment Agreement (\$1.57 per share) net of \$75,000 of expenses	-	-
Sale of Series 2002 Preferred Stock in connection with the Standby Agreement (\$1,000 per share) net of \$115,000 of expenses	-	-
Sale of Series C Preferred Stock (\$1,000 per share) net of \$23,000 of expenses	-	-
Sale of warrants to investor in connection with the Standby Agreement	-	-
Deemed dividend related to beneficial conversion feature on Series B Preferred Stock	-	-
Issuance of warrants to lender	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for services	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2002	500,000	5,000

Edgar Filing: BLUEFLY INC - Form 10-K

Sale of Series D Preferred Stock (\$1,000 per share)	-	-
Exchange of note for Series D Preferred Stock (\$1,000 per share)	-	-
Conversion of January 2003 Note to Series D Preferred Stock	-	-
Sale of Series E Preferred Stock (\$1,000 per share)	-	-
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	-	-
Exercise of Employee Stock Options and Warrants	-	-
Conversion of Series 2002 Preferred Stock to Series D Preferred Stock	-	-
Conversion of Series A Preferred Stock and Series B Preferred Stock to Common Stock	(40,000)	-
Issuance of warrants to supplier	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for obligations	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2003	460,000	5,000
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000)	-	-
Change in Value of Warrants	-	-
Exercise of Employee Stock Options	-	-
Expense recognized in connection with Issuance of Options	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2004	460,000	\$ 5,000

SERIES C PREFERRED STOCK \$.01 PAR VALUE		
	NUMBER OF SHARES	AMOUNT
BALANCE AT JANUARY 1, 2002	-	\$ -
Sale of common stock in connection with the Standby Commitment Agreement (\$1.57 per share) net of \$75,000 of expenses	-	-
Sale of Series 2002 Preferred Stock in connection with the Standby Agreement (\$1,000 per share) net of \$115,000 of expenses	-	-
Sale of Series C Preferred Stock (\$1,000 per share) net of \$23,000 of expenses	1,000	-

Edgar Filing: BLUEFLY INC - Form 10-K

Sale of warrants to investor in connection with the Standby Agreement	-	-
Deemed dividend related to beneficial conversion feature on Series B Preferred Stock	-	-
Issuance of warrants to lender	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for services	-	-
Net loss	-	-
	-----	-----
BALANCE AT DECEMBER 31, 2002	1,000	-
	-----	-----
Sale of Series D Preferred Stock (\$1,000 per share)	-	-
Exchange of note for Series D Preferred Stock (\$1,000 per share)	-	-
Conversion of January 2003 Note to Series D Preferred Stock	-	-
Sale of Series E Preferred Stock (\$1,000 per share)	-	-
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	-	-
Exercise of Employee Stock Options and Warrants	-	-
Conversion of Series 2002 Preferred Stock to Series D Preferred Stock	-	-
Conversion of Series A Preferred Stock and Series B Preferred Stock to Common Stock	-	-
Issuance of warrants to supplier	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for obligations	-	-
Net loss	-	-
	-----	-----
BALANCE AT DECEMBER 31, 2003	1,000	-
	-----	-----
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000)	-	-
Change in Value of Warrants	-	-
Exercise of Employee Stock Options	-	-
Expense recognized in connection with Issuance of Options	-	-
Net loss	-	-
	=====	=====
BALANCE AT DECEMBER 31, 2004	1,000	\$ -
	=====	=====

SERIES E PREFERRED STOCK
\$.01 PAR VALUE

NUMBER OF

Edgar Filing: BLUEFLY INC - Form 10-K

	SHARES	AMOUNT
	-----	-----
BALANCE AT JANUARY 1, 2002	-	\$ -
Sale of common stock in connection with the Standby Commitment Agreement (\$1.57 per share) net of \$75,000 of expenses	-	-
Sale of Series 2002 Preferred Stock in connection with the Standby Agreement (\$1,000 per share) net of \$115,000 of expenses	-	-
Sale of Series C Preferred Stock (\$1,000 per share) net of \$23,000 of expenses	-	-
Sale of warrants to investor in connection with the Standby Agreement	-	-
Deemed dividend related to beneficial conversion feature on Series B Preferred Stock	-	-
Issuance of warrants to lender	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for services	-	-
Net loss	-	-
	-----	-----
BALANCE AT DECEMBER 31, 2002	-	-
	-----	-----
Sale of Series D Preferred Stock (\$1,000 per share)	-	-
Exchange of note for Series D Preferred Stock (\$1,000 per share)	-	-
Conversion of January 2003 Note to Series D Preferred Stock	-	-
Sale of Series E Preferred Stock (\$1,000 per share)	1,000	-
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	-	-
Exercise of Employee Stock Options and Warrants	-	-
Conversion of Series 2002 Preferred Stock to Series D Preferred Stock	-	-
Conversion of Series A Preferred Stock and Series B Preferred Stock to Common Stock	-	-
Issuance of warrants to supplier	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for obligations	-	-
Net loss	-	-
	-----	-----
BALANCE AT DECEMBER 31, 2003	1,000	-
	-----	-----
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000)	-	-
Change in Value of Warrants	-	-

Edgar Filing: BLUEFLY INC - Form 10-K

Exercise of Employee Stock Options	-	-
Expense recognized in connection with Issuance of Options	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2004	1,000	\$ -

COMMON STOCK \$.01 PAR VALUE		
	NUMBER OF SHARES	AMOUNT
BALANCE AT JANUARY 1, 2002	9,205,331	\$ 92,000
Sale of common stock in connection with the Standby Commitment Agreement (\$1.57 per share) net of \$75,000 of expenses	1,186,573	12,000
Sale of Series 2002 Preferred Stock in connection with the Standby Agreement (\$1,000 per share) net of \$115,000 of expenses	-	-
Sale of Series C Preferred Stock (\$1,000 per share) net of \$23,000 of expenses	-	-
Sale of warrants to investor in connection with the Standby Agreement	-	-
Deemed dividend related to beneficial conversion feature on Series B Preferred Stock	-	-
Issuance of warrants to lender	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for services	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2002	10,391,904	104,000
Sale of Series D Preferred Stock (\$1,000 per share)	-	-
Exchange of note for Series D Preferred Stock (\$1,000 per share)	-	-
Conversion of January 2003 Note to Series D Preferred Stock	-	-
Sale of Series E Preferred Stock (\$1,000 per share)	-	-
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	-	-
Exercise of Employee Stock Options and Warrants	1,869,598	19,000
Conversion of Series 2002 Preferred Stock to Series D Preferred Stock	-	-
Conversion of Series A Preferred Stock and Series B Preferred Stock	-	-

Edgar Filing: BLUEFLY INC - Form 10-K

to Common Stock	632,664	6,000
Issuance of warrants to supplier	-	-
Issuance of warrants to shareholders	-	-
Issuance of warrants in exchange for obligations	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2003	12,894,166	129,000
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000)	1,543,209	15,000
Change in Value of Warrants	-	-
Exercise of Employee Stock Options	804,381	8,000
Expense recognized in connection with Issuance of Options	-	-
Net loss	-	-
BALANCE AT DECEMBER 31, 2004	15,241,756	\$ 152,000

	ACCUMULATED DEFICIT	TOTAL SHAREHOLDERS' EQUITY
	-----	-----
BALANCE AT JANUARY 1, 2002	\$ (63,968,000)	\$ 8,402,000
Sale of common stock in connection with the Standby Commitment Agreement (\$1.57 per share) net of \$75,000 of expenses	-	1,788,000
Sale of Series 2002 Preferred Stock in connection with the Standby Agreement (\$1,000 per share) net of \$115,000 of expenses	-	1,985,000
Sale of Series C Preferred Stock (\$1,000 per share) net of \$23,000 of expenses	-	977,000
Sale of warrants to investor in connection with the Standby Agreement	-	37,000
Deemed dividend related to beneficial conversion feature on Series B Preferred Stock	(15,295,000)	-
Issuance of warrants to lender	-	80,000
Issuance of warrants to shareholders	-	255,000
Issuance of warrants in exchange for services	-	39,000
Net loss	(6,479,000)	(6,479,000)
BALANCE AT DECEMBER 31, 2002	(85,742,000)	7,084,000
Sale of Series D Preferred Stock (\$1,000 per share)	-	2,000,000
Exchange of note for Series D Preferred Stock (\$1,000 per share)	-	2,027,000
Conversion of January 2003 Note to Series D Preferred Stock	-	1,009,000

Edgar Filing: BLUEFLY INC - Form 10-K

Sale of Series E Preferred Stock (\$1,000 per share)	-	1,000,000
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	(225,000)	-
Exercise of Employee Stock Options and Warrants	-	2,966,000
Conversion of Series 2002 Preferred Stock to Series D Preferred Stock	-	-
Conversion of Series A Preferred Stock and Series B Preferred Stock to Common Stock	-	-
Issuance of warrants to supplier	-	503,000
Issuance of warrants to shareholders	-	42,000
Issuance of warrants in exchange for obligations	-	17,000
Net loss	(6,369,000)	(6,369,000)
BALANCE AT DECEMBER 31, 2003	(92,336,000)	10,279,000
Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000)	-	4,577,000
Change in Value of Warrants	-	(564,000)
Exercise of Employee Stock Options	-	741,000
Expense recognized in connection with Issuance of Options	-	147,000
Net loss	(3,791,000)	(3,791,000)
BALANCE AT DECEMBER 31, 2004	\$ (96,127,000)	\$ 11,389,000

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

F-4

BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2004, 2003 and 2002

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (3,791,000)	\$ (6,369,000)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	1,342,000	1,744,000
Loss on disposal of assets	35,000	
Non-cash expense related to warrants issued to supplier	264,000	
Change in value of warrants	(564,000)	
Provision for returns	(354,000)	803,000
Allowance for doubtful accounts	237,000	131,000

Edgar Filing: BLUEFLY INC - Form 10-K

Reserve for inventory obsolescence	100,000	484,000
Stock option expense	147,000	
Changes in operating assets and liabilities		
(Increase) decrease in		
Inventories	(1,982,000)	(956,000)
Accounts receivable	(289,000)	(455,000)
Other current assets	(269,000)	(124,000)
Prepaid expenses	(127,000)	(5,000)
Other assets	-	
(Decrease) increase in:		
Accounts payable	1,068,000	61,000
Accrued expenses	186,000	(124,000)
Short term interest payable to related party		
shareholders	20,000	28,000
Deferred revenue	445,000	367,000
Long-term interest payable to related party		
shareholders	499,000	159,000
	-----	-----
Net cash used in operating activities	(3,033,000)	(4,256,000)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash collateral in connection with Rosenthal Pledge Agreement	(1,250,000)	
Purchase of property and equipment	(1,486,000)	(481,000)
	-----	-----
Net cash used in investing activities	(2,736,000)	(481,000)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from January 2004 financing	4,577,000	
Net proceeds from exercise of Stock Options	741,000	2,966,000
Payments of capital lease obligation	(349,000)	(257,000)
Repayment of related party notes	(236,000)	
Proceeds from issuance of Notes Payable (October 2003 Financing)	-	2,000,000
Proceeds from issuance of Notes Payable (July 2003 Financing)	-	2,000,000
Proceeds from sale of Series D Preferred Stock	-	2,000,000
Proceeds from issuance of Notes Payable (January 2003 Financing)	-	1,000,000
Proceeds from sale of Series E Preferred Stock	-	1,000,000
Net proceeds from sale of Series 2002 Preferred Stock	-	
Proceeds from issuance of Notes Payable (September 2002 Financing)	-	
Net proceeds from sale of Common Stock and Warrants	-	
Net proceeds from sale of Series C Preferred Stock	-	
	-----	-----
Net cash provided by financing activities	4,733,000	10,709,000
	-----	-----
Net increase (decrease) in cash and cash equivalents	(1,036,000)	5,972,000
	-----	-----
CASH AND CASH EQUIVALENTS		
Beginning of year	7,721,000	1,749,000
	-----	-----
End of year	\$ 6,685,000	\$ 7,721,000
	=====	=====
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for Interest	\$ 175,000	\$ 85,000
Non-cash investing and financing activities		
Equipment acquired under capital lease	153,000	224,000
Exchange of note for equity	-	2,027,000
Conversion of debt to equity	-	1,009,000
Warrants issued to supplier	-	503,000
Deemed dividend related to beneficial conversion feature on Series C Preferred Stock	-	225,000
Warrants issued to related party shareholders	-	42,000
Deemed dividend related to beneficial conversion feature on		

Edgar Filing: BLUEFLY INC - Form 10-K

Series B Preferred Stock	-
Warrant issued in exchange for obligation	-
Warrant issued to lender	-

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

F-5

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

1. THE COMPANY

Bluefly, Inc., a Delaware corporation, (the "Company"), is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discount prices. The Company's Web site was launched in September 1998.

The Company has sustained net losses and negative cash flows from operations since the formation of Bluefly.com. The Company's ability to meet its obligations in the ordinary course of business is dependent upon its ability to establish profitable operations or raise additional financing through public or private debt or equity financing, or other sources of financing to fund operations. The Company believes that its existing resources, together with working capital should be sufficient to satisfy our cash requirements through December 31, 2005. The Company may seek additional equity or debt financings to maximize the growth of its business or if anticipated operating results are not achieved. If such financings are not available on terms acceptable to the Company, and/or the Company does not achieve its sales plan, future operations will need to be modified, scaled back or discontinued.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

REVENUE RECOGNITION

The Company recognizes revenue in accordance with Staff Accounting Bulletin ("SAB 101") 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 tax. 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.

Edgar Filing: BLUEFLY INC - Form 10-K

. The product has been shipped and received by the customer.

Shipping and handling billed to customers is 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").

F-6

BLUEFLY, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2004

PROVISIONS FOR SALES RETURNS AND DOUBTFUL ACCOUNTS

The Company generally permits returns for any reason within 90 days of the sale. The Company performs credit card authorizations and checks the verifications of its customers prior to shipment of merchandise. Accordingly, the Company establishes a reserve for estimated future sales returns and allowance for doubtful accounts at the time of shipment based primarily on historical data. Accounts receivable is presented on the consolidated balance sheet net of the allowance for doubtful accounts. As of December 31, 2004 and 2003, the allowance for doubtful accounts was \$44,000 and \$40,000, respectively, and the allowance for sales returns was \$2,174,000 and \$2,528,000, respectively.

Deferred revenue, which consists primarily of goods shipped to customers but not yet received and customer credits, totaled approximately \$1,697,000 and \$1,252,000 as of December 31, 2004 and 2003, respectively.

CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents.

INVENTORIES

Inventories, which consist of finished goods, are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method. The Company reviews its inventory levels in order to identify slow-moving merchandise and establishes a reserve for such merchandise. Inventory reserves are established based on historical data and management's best estimate of excess inventory. Inventory may be marked down below cost if management determines that the inventory stock will not sell at its currently marked price. Inventory is presented net of reserves on the consolidated balance sheet.

As of December 31, 2004 and 2003, inventories, net consists of the following:

	2004	2003
	-----	-----
Inventory on hand	\$ 12,433,000	\$ 10,755,000
Inventory to be received due to returns	1,360,000	1,258,000
Inventory reserves	(835,000)	(673,000)
	-----	-----
Total inventories, net	\$ 12,958,000	\$ 11,340,000
	=====	=====

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost net of depreciation. Equipment and software are depreciated on a straight-line basis over two to seven

Edgar Filing: BLUEFLY INC - Form 10-K

years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the lease. Lease amortization is included in depreciation expense. Maintenance and repairs are expensed as incurred.

Certain equipment held under capital leases is classified as property and equipment and amortized using the straight-line method over the lease terms and the related obligations are recorded as liabilities.

F-7

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

Costs related to the upgrade and development of the Web Site are accounted for in accordance with EITF Issue No. 00-02 "Accounting for Website Development Costs", and to the extent they are capitalized, are amortized over 24 months.

LONG-LIVED ASSETS

The Company's policy is to evaluate long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. This evaluation is based on a number of factors, including expectations for operating income and undiscounted cash flows that will result from the use of such assets. The Company has not identified any such impairment of assets.

INCOME TAXES

The Company recognizes deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory tax 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 or loss in the period that includes the enactment date. In addition, valuation allowances are established when it is more likely than not that deferred tax assets will not be realized.

STOCK BASED COMPENSATION

At December 31, 2004, the Company has two stock-based employee compensation plans, which are described more fully in Note 9. 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 year ended December 31, 2004, compensation expense of \$17,000 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, and \$113,000 in compensation expense was recorded in connection with certain options issued to the Company's former Chief Executive Officer pursuant to his separation agreement. Except for these options, no compensation expense has been recorded for the year ended December 31, 2004 and December 31, 2003 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

Edgar Filing: BLUEFLY INC - Form 10-K

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:

F-8

BLUEFLY, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2004

	YEAR ENDED DECEMBER 31,		
	2004	2003	2002
Net loss, as reported	\$ (3,791,000)	\$ (6,369,000)	\$ (6,479,000)
Deduct: total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(4,617,000)	(4,219,000)	(4,259,000)
Add: Stock-based employee compensation expense included in reported net loss	130,000	-	-
Pro forma net loss	(8,278,000)	(10,588,000)	(10,738,000)
Loss per share			
Basic and diluted, as reported	\$ (0.55)	\$ (0.88)	\$ (2.44)
Basic and diluted, pro forma	\$ (0.86)	\$ (1.26)	\$ (2.87)

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

NET LOSS PER SHARE

The Company calculated net loss per share in accordance with 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. For purposes of calculating basic and diluted loss per share, the Company presents the amount of dividends earned but unpaid on the face of the statement of operations.

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, the following shares of Common Stock issuable pursuant to options, warrants, Preferred Stock and Convertible Notes were not included in the computation of diluted earnings per share because the result of such inclusion would be antidilutive:

COMMON STOCK ISSUABLE			
2004	2003	2002	EXE PR

SECURITY

Edgar Filing: BLUEFLY INC - Form 10-K

Options	9,813,379	8,508,370	8,508,412	\$0.69
Warrants	1,704,945	1,319,144	1,069,144	\$0.78
Preferred stock	43,323,430 (1)	43,323,430 (1)	27,769,450	
Convertible Notes(2)	-	-	2,150,538	

(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) Represents 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 holder's 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.

F-9

BLUEFLY, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2004

MARKETING EXPENSES

In addition to marketing salaries, marketing expenses consist primarily of online advertising, print advertising, costs associated with sweepstakes, direct mail campaigns as well as the related external production costs. The costs associated with online and print advertising are expensed as incurred, while the costs associated with direct mail campaigns are capitalized and charged to expense over the expected future revenue stream. There were no amounts associated with direct mail campaigns capitalized at December 31, 2004 and 2003. Marketing expenses (excluding marketing and public relations salaries and related salary expenses of \$761,000, \$628,000 and \$553,000) for the years ended December 31, 2004, 2003 and 2002 amounted to approximately \$1,452,000, \$1,270,000 and \$1,722,000, respectively.

FULFILLMENT EXPENSES

The Company utilizes a third party to perform all of its order fulfillment including warehousing, administrative support, returns processing and receiving labor. For the years ended December 31, 2004, 2003 and 2002, fulfillment expenses totaled \$2,914,000, \$2,776,000 and \$2,622,000, respectively. These amounts are included in selling, marketing and fulfillment expenses in the statement of operations.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, other assets, accounts payable, accrued liabilities, and notes payable to related party shareholders approximate fair value due to their short maturities.

RECENT ACCOUNTING PRONOUNCEMENTS

In March, 2004, the Emerging Issues Task Force issued EITF 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128." This statement provides additional guidance on the calculation and disclosure requirements for earnings per share. The FASB concluded in EITF 03-6 that companies with multiple classes of common stock or participating securities, as defined by SFAS No. 128, calculate and disclose earnings per share based on the two-class method. The adoption

Edgar Filing: BLUEFLY INC - Form 10-K

of this statement does not have an impact to the Company's financial statement presentation as the Company is currently in a loss position.

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 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 financial condition or cash flows but is expected to have a significant, adverse effect on its results of operations.

RECLASSIFICATIONS

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

F-10

BLUEFLY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004

USE OF 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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions include the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment and the realization of deferred tax assets. Actual results could differ from those estimates.

3. PROPERTY AND EQUIPMENT

As of December 31, 2004 and 2003, property and equipment consists of the following:

	2004	2003
Leasehold improvements	\$ 1,065,000	\$ 544,000
Office equipment	483,000	433,000
Computer equipment and software	5,619,000	4,550,000
	7,167,000	5,527,000
Less: Accumulated depreciation	(5,234,000)	(3,868,000)
	\$ 1,933,000	\$ 1,659,000

Edgar Filing: BLUEFLY INC - Form 10-K

Depreciation and amortization of property and equipment was approximately \$1,331,000, \$1,650,000 and \$1,000,000, for the years ended December 31, 2004, 2003 and 2002, respectively.

4. PREPAID EXPENSES AND OTHER CURRENT ASSETS

As of December 31, 2004 and 2003, prepaid expenses and other current assets consist of the following:

	2004	2003
	-----	-----
Prepaid expenses	\$ 296,000	\$ 232,000
Prepaid inventory	335,000	273,000
Other current assets	722,000	201,000
	-----	-----
	\$ 1,353,000	\$ 706,000
	=====	=====

F-11

BLUEFLY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004

5. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

As of December 31, 2004 and 2003, accrued expenses and other current liabilities consist of the following:

	2004	2003
	-----	-----
Allowance for sales returns	\$ 2,174,000	\$ 2,528,000
Salary, vacation and bonus accrual	721,000	550,000
Current portion of capital lease liability	139,000	314,000
Accrued expenses	354,000	240,000
Deposit from third party	-	170,000
Accrued media expenses	138,000	67,000
	-----	-----
	\$ 3,526,000	\$ 3,869,000
	=====	=====

6. OTHER INCOME

In June 2002, the Company entered into an agreement with a third party investor pursuant to which the investor committed to purchase approximately \$7 million of Common Stock and warrants from the Company. The investor breached the contract by failing to consummate the investment, although it did provide the Company with \$169,000 as a good faith deposit. In October 2002, the Company filed an action against the investor based on its failure to consummate the investment, and in December 2003, the court entered judgment in the Company's favor against the third party investor in the amount of \$3,793,688. In the first quarter of 2004, following the expiration of all applicable appeal periods, the Company recognized the good faith deposit of \$169,000 as other income, as a partial recognition of litigation settlement. Based on the information currently available to it regarding the investor's finances, the Company does not believe that it will be successful in collecting a material amount of additional funds as a result of the damages award.

Edgar Filing: BLUEFLY INC - Form 10-K

In addition, as discussed in Note 9 below, the Company recognized \$564,000 of other income for the year ended December 31, 2004 to adjust a liability associated with warrants issued by the Company to its fair value as of June 17, 2004 (at which point the liability was reclassified as equity in accordance with EITF 00-19 and described in Note 9).

F-12

BLUEFLY, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2004

7. INCOME TAXES

Significant components of the Company's deferred tax assets and liabilities are summarized as follows:

	2004	2003
	-----	-----
DEFERRED TAX ASSETS		
Net operating losses	\$ 27,328,000	\$ 26,230,000
Depreciation and amortization	(99,000)	(142,000)
Accounts receivable and inventory reserves	350,000	288,000
Accrued bonuses	203,000	134,000
Deferred revenue	686,000	357,000
Other	270,000	5,000
	-----	-----
Valuation Allowance	28,738,000 (28,738,000)	26,872,000 (26,872,000)
	-----	-----
Net deferred tax asset (liability)	\$ -	\$ -
	=====	=====

The Company is in an accumulated loss position for both financial and income tax reporting purposes. The Company has U.S. Federal net operating loss carryforwards of approximately \$67,627,000 at December 31, 2004 which have expiration dates from 2018 through 2024. Approximately \$5.3 million of these net operating loss carryforwards relate to the exercise of employee stock options and any tax benefit derived there from, when realized, will be accounted for as a credit to additional paid-in-capital rather than a reduction of the income tax provision. Pursuant to Section 382 of the Internal Revenue Code, the usage of these net operating loss carryforwards may be limited due to changes in ownership that have occurred or that may occur in the future. The Company has not yet determined the impact, if any, that changes in ownership have had on net operating loss carryforwards. The Company provided a full valuation allowance on the entire deferred tax asset balance to reflect the uncertainty regarding the realizability of these assets due to operating losses incurred since inception.

The Company's effective tax rate differs from the U.S. Federal Statutory income tax rate of 35% as follows:

	2004	2003	2002
	-----	-----	-----
Statutory federal income tax rate	(35.00)%	(35.00)%	(35.00)%
State tax benefit, net of federal taxes	(5.41)%	(5.41)%	(5.41)%

Edgar Filing: BLUEFLY INC - Form 10-K

Other	0.34%	0.16%	0.55%
Valuation allowance on deferred tax asset	40.07%	40.25%	39.86%
	-----	-----	-----
Effective tax rate	0.00%	0.00%	0.00%
	=====	=====	=====

F-13

BLUEFLY, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2004

8. COMMITMENTS AND CONTINGENCIES

EMPLOYMENT CONTRACTS

The Company has entered into certain employment contracts, which expire through September 30, 2007. As of December 31, 2004, the Company's aggregate commitment for future base salary under these employment contracts is:

2005	\$ 1,219,000
2006	1,030,000
2007	324,000

	\$ 2,573,000
	=====

LEASES

The Company leases equipment and space under various capital and operating leases that expire at various dates through 2011. Future minimum lease payments under capital and operating leases, excluding utilities, that have initial or remaining non-cancelable terms in excess of one year are as follows:

	CAPITAL LEASES	OPERATING LEASES
	-----	-----
2005	\$ 139,000	\$ 462,000
2006	54,000	469,000
2007	27,000	481,000
2008	-	441,000
Thereafter	-	476,000
	-----	-----
Total minimum payments	220,000	\$ 2,329,000
	-----	=====
Obligations due within one year	(139,000)	

Long-term obligations under capital leases	\$ 81,000	
	=====	

Rent expense aggregated approximately \$442,000, \$427,000 and \$412,000 for the years ended December 31, 2004, 2003 and 2002, respectively.

MARKETING COMMITMENTS

As of December 31, 2004, the Company has advertising and marketing commitments in connection with email services of approximately \$150,000 through December 31, 2005.

Edgar Filing: BLUEFLY INC - Form 10-K

LEGAL PROCEEDINGS

The Company is, from time to time, involved in litigation incidental to the conduct of its business. However, the Company is not party to any lawsuit or proceeding which, in the opinion of management is likely to have a material adverse effect on its financial condition.

F-14

BLUEFLY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004

9. SHAREHOLDERS' EQUITY

AUTHORIZED SHARES

The Company is incorporated in Delaware and has 92,000,000 authorized shares of common stock, \$.01 par value per share ("Common Stock"), and 25,000,000 authorized shares of preferred stock, \$.01 par value per share (the "Preferred Stock"). The Preferred Stock is designated as follows: 500,000 shares of Series A Convertible Preferred Stock (the "Series A Preferred Stock"); 9,000,000 shares of Series B Convertible Preferred Stock (the "Series B Preferred Stock"); 3,500 shares of Series C Convertible Preferred Stock (the "Series C Preferred Stock"); 2,100 shares of Series 2002 Convertible Preferred Stock (the "Series 2002 Convertible Preferred Stock"); 7,150 shares of Series D Convertible Preferred Stock (the "Series D Preferred Stock"); 1,000 shares of Series E Convertible Preferred Stock (the "Series E Preferred Stock"); and 15,486,250 shares undesignated and available for issuance.

PREFERRED STOCK

OUTSTANDING SHARES

The Company's currently outstanding shares of Preferred Stock (collectively, the "Outstanding Preferred Stock") include the following: 460,000 shares of Series A Preferred Stock with a stated value of \$9.2 million; 8,889,414 shares of Series B Preferred Stock with a stated value of \$20 million; 1,000 shares of Series C Preferred Stock with a stated value of \$1.0 million; 7,136.548 shares of Series D Preferred Stock with a stated value of approximately \$7.1 million; and 1,000 shares of Series E Preferred Stock with a stated value of approximately \$1.0 million. All such shares are held by affiliates of Soros Private Equity Partners, LLC ("Soros") that collectively own a majority of the Company's capital stock.

LIQUIDATION PREFERENCE

Each share of Outstanding Preferred Stock has a liquidation preference equal to the greater of (i) its stated value plus accrued dividends (and, in the case of the Series B Preferred Stock an additional \$10 million, resulting in an aggregate liquidation preference for all Outstanding Preferred Stock of \$49,100,000 plus accrued dividends of \$14.3 million) or (ii) the amount that the holder of such share would receive if it were to convert such share into shares of Common Stock immediately prior to the liquidation, dissolution or winding up of the Company. The liquidation preference and accrued dividends on each series of Preferred Stock at December 31, 2004 is as follows:

STATED VALUE	ACCRUED DIVIDENDS AT DECEMBER 31, 2004	LIQUIDATION PREFERENCE
-----	-----	-----

Edgar Filing: BLUEFLY INC - Form 10-K

Series A Preferred Stock	\$ 9,200,000	\$ 5,000,000	\$ 14,200,000
Series B Preferred Stock	20,800,000	7,300,000	38,100,000 (1)
Series C Preferred Stock	1,000,000	191,000	1,191,000
Series D Preferred Stock	7,100,000	1,600,000	8,700,000
Series E Preferred Stock	1,000,000	202,000	1,202,000
	-----	-----	-----
	\$ 39,100,000	\$ 14,293,000	\$ 63,393,000
	=====	=====	=====

(1) Includes \$10 million of additional liquidation preference in connection with Series B Preferred Stock

F-15

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

DIVIDENDS

Each share of Outstanding Preferred Stock bears a cumulative compounding dividend, payable upon conversion in cash or Common Stock, at the Company's option. The Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock accrue dividends at the rate of 8% per annum, and the Series D Preferred Stock and Series E Preferred Stock accrue dividends at the rate of 12% per annum.

RANKING

All of the shares of Outstanding Preferred Stock rank pari passu with each other, and senior to the Common Stock, with respect to the payment of distributions on liquidation, dissolution or winding up of the Company and with respect to the payment of dividends.

CONVERSION

The Series A Preferred Stock is convertible into Common Stock at the rate of \$2.34 in stated value per share of Common Stock. The other shares of Outstanding Preferred Stock are convertible into Common Stock at the rate of \$0.76 in stated value per share of Common Stock. The conversion price of all of the Outstanding Preferred Stock, other than the Series A Preferred Stock, is subject to anti-dilution adjustments, pursuant to which, subject to certain exceptions, to the extent that the Company issues Common Stock or securities convertible into Common Stock at a price per share less than the conversion price in the future, the conversion price would be decreased so that it would equal the conversion price of the new security or the price at which shares of Common Stock are sold, as the case may be. As more fully described below, the conversion price of the Series B Preferred Stock and the Series C Preferred Stock were reduced from higher levels to \$0.76 upon the issuance of the Series D Preferred Stock as a result of these anti-dilution provisions.

VOTING RIGHTS

All of the shares of Outstanding Preferred Stock vote with the Common Stock on an as-converted basis, and the Company is prohibited from taking certain actions without the approval of a majority of each of the separate classes of Outstanding Preferred Stock. In addition, the holders of the Series A Preferred Stock have the right to appoint a designee to the Company's Board of Directors (the "Series A Designee"), and the holders of the Series B Preferred Stock similarly have the right

Edgar Filing: BLUEFLY INC - Form 10-K

to appoint such a designee (the "Series B Designee"), with both the Series A Designee and the Series B Designee being entitled to seven votes on any issue that comes before the Board of Directors (other than issues relating to the redemption of the Outstanding Preferred Stock, as described below).

REDEMPTION

The Company is entitled, subject to certain conditions, to redeem the shares of Outstanding Preferred Stock for cash at prices ranging, depending upon the date of such redemption, from 4 times, 4.5 times or 5 times the conversion price. The directors designated by the holders of the Preferred Stock are not entitled to vote on issues relating to the redemption of the Outstanding Preferred Stock.

MISCELLANEOUS RIGHTS

The holders of the Outstanding Preferred Stock have registration rights with respect to the Common Stock issuable upon conversion of the Outstanding Preferred Stock and pre-emptive rights with respect to future issuance of capital stock of the Company.

F-16

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

JANUARY 2004 FINANCING

In January 2004, the Company completed a private placement pursuant to which it raised \$5,000,000 (the "January 2004 Financing"). Under the terms of the deal, the Company issued 1,543,209 shares of Common Stock at \$3.24 per share, which was 90% of the trailing five-day average of the Company's volume-weighted stock price as of December 29, 2003, the date that a preliminary agreement was reached as to the pricing of the deal. The Company also issued to the new investors warrants to purchase 385,801 shares of Common Stock at any time during the next five years at an exercise price equal to \$3.96 per share. After professional fees and finders fees paid to brokers, the net proceeds from the transaction were approximately \$4,577,000.

SOROS FINANCINGS DURING 2003 CONVERSION OF PREFERRED STOCK

In January 2003, the holders of 40,000 shares of the Company's Series A Convertible Preferred Stock and 21,368 shares of the Company's Series B Convertible Preferred Stock exercised their conversion rights with respect thereto. The shares of Series A Convertible Preferred Stock were converted into an aggregate of 341,880 shares of the Company's Common Stock. In addition, as permitted under the Company's Certificate of Incorporation, the Company elected to pay the \$213,216 in accrued and unpaid dividends on such shares of Series A Preferred Stock through the issuance of additional shares of Common Stock at a price per share of \$0.93 (the 30-day trailing average closing price as of the date of conversion). Accordingly, an additional 229,265 shares of the Company's Common Stock were issued as payment in full of the accrued and unpaid dividends on the converted shares of Series A Convertible Preferred Stock, in accordance with the Company's Certificate of Incorporation. The shares of Series B Convertible Preferred Stock were converted into an aggregate of 53,765 shares of the Company's Common Stock. In addition, as permitted under the Company's Certificate of Incorporation, the Company elected to pay the \$7,211 in accrued and unpaid dividends on such shares of Series B Preferred Stock through the issuance of

Edgar Filing: BLUEFLY INC - Form 10-K

additional shares of Common Stock at a price per share of \$0.93 (the 30-day trailing average closing price as of the date of conversion). Accordingly, an additional 7,754 shares of the Company's Common Stock were issued as payment in full of the accrued and unpaid dividends on the converted shares of Series B Convertible Preferred Stock, in accordance with the Company's Certificate of Incorporation.

JANUARY 2003 FINANCING

In January 2003, the Company issued to Soros \$1 million of demand convertible promissory notes that bore interest at a rate of 8% per annum and had a maturity date of July 28, 2003, and warrants to purchase 25,000 shares of its common stock, exercisable at any time on or prior to January 28, 2007 at \$1.12 per share (the "January 2003 Financing"). Interest on the notes was payable only upon repayment of the principal amount, whether at maturity or upon a mandatory or optional prepayment. The principal amount, together with accrued interest, was convertible into equity securities that the Company might issue in any subsequent round of financing, at the holder's option, at a price that was equal to the lowest price per share accepted by any investor in such subsequent round of financing. These notes were converted into Series D Preferred Stock in connection with the March 2003 Financing described below.

MARCH 2003 FINANCING

In March 2003, the Company entered into an agreement with Soros pursuant to which Soros: (i) provided \$2 million of new capital by purchasing 2,000 shares of Series D Preferred Stock, (ii) converted the promissory notes issued to it in the January 2003 Financing and all of its Series 2002 Preferred Stock into 3,109.425 shares of Series D Preferred Stock and (iii) purchased 2,027.123

F-17

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

shares of Series D Preferred Stock, with the proceeds from this sale being retained by Soros as payment in full of the Company's obligations under the Series C Notes (the "March 2003 Financing"). The material terms of the Series D Preferred Stock are described above.

Additionally, Soros agreed to provide the Company with up to \$1 million in additional financing (the "2003 Standby Commitment Amount") on a standby basis at any time prior to January 1, 2004, provided that the Company's cash balances were less than \$1 million at that time (the "2003 Standby Commitment.") Such financing was to be made in one or more tranches as determined by the members of the Company's Board of Directors (other than the Series A Designee and the Series B Designee), and any and all draws against the 2003 Standby Commitment Amount were to be effected through the purchase of newly-designated shares of Series E Preferred Stock. Subject to certain limitations, the 2003 Standby Commitment Amount was to be reduced on a dollar-for-dollar basis by the gross cash proceeds received by the Company or any of its subsidiaries from the issuance of any equity or convertible securities after March 12, 2003.

As a result of the March 2003 Financing, the conversion price of the Series B Preferred Stock and the Series C Preferred Stock automatically decreased from \$0.93 to \$0.76 per share. In accordance with EITF 00-27, the reduction in the conversion price of the Series C Preferred Stock

Edgar Filing: BLUEFLY INC - Form 10-K

resulted in the Company recording a beneficial conversion feature in the approximate amount of \$225,000 as part of its financial results for the first quarter of 2003. This non-cash charge, which is analogous to a dividend, resulted in an adjustment to the Company's computation of Loss Per Share.

MAY 2003 FINANCING

In accordance with the terms of the 2003 Standby Commitment, in May 2003 Soros invested an additional \$1.0 million in the Company through the purchase of 1,000 shares of Series E Preferred Stock and thereby fulfilled the 2003 Standby Commitment in full. The terms of the Series E Preferred Stock are described above.

JULY 2003 FINANCING

In July 2003, Soros invested an additional \$2.0 million in the Company. Under the terms of the transaction, the Company issued \$2.0 million of convertible promissory notes that bear interest at a rate of 12% per annum and had a maturity date of January 12, 2004 (which, was subsequently extended to May 1, 2006). Interest on the notes is payable only upon repayment of the principal amount, whether at maturity or upon a mandatory or optional prepayment. The principal amount, together with accrued interest, is convertible into equity securities of the Company sold in any subsequent round of financing, at the holder's option, at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing (the "July 2003 Financing"). The conversion of the notes is subject to certain limitations until such time as the conversion provisions are approved by the Company's stockholders.

OCTOBER 2003 FINANCING

In October 2003 Soros invested an additional \$2.0 million in the Company. Under the terms of the transaction, the Company issued \$2.0 million of convertible promissory notes. These notes were on substantially the same terms as the notes issued in the July 2003 Financing, except that the maturity date of these notes was April 14, 2004. Subsequent to year end, the maturity date of these notes was extended to May 1, 2006.

F-18

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

WARRANTS

WARRANTS TO SOROS

The Company has issued warrants to Soros in connection with past and recent financings as well as in connection with the Loan Facility. Warrants issued in connection with the Company's Loan Facility are included in the table below and are described more fully in Note 11 below.

In connection with the January 2003 Financing, the Company issued warrants to purchase 25,000 shares of its common stock, exercisable at any time on or prior to January 28, 2007 at \$1.12 per share to Soros.

The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 3.54%, volatility 113%, expected life 4 years, zero dividend yield. Using these factors the warrants were valued at \$21,000 and were expensed over the

Edgar Filing: BLUEFLY INC - Form 10-K

life of the note. The full amount was expensed in the first quarter of 2003.

In exchange for the March 2002 Standby Agreement, the Company issued to Soros warrants to purchase 100,000 shares of Common Stock at an exercise price of \$1.68 per share (the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance), exercisable at any time until March 27, 2007. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 5.22%, volatility 183%, expected life 3 years, zero dividend yield. The Company accounted for the warrants by crediting additional paid in capital for approximately \$157,000 and capitalizing the amount on the balance sheet. This amount was then netted against the proceeds from the subsequent May 2003 Financing and July 2003 Financing described above, on a pro rata basis.

WARRANTS TO SUPPLIER

On December 22, 2003 the Company issued warrants to purchase 250,000 shares of Common Stock at an exercise price of \$2.34 per share to a supplier of inventory in exchange for reduced pricing. The warrants are fully vested and expire on December 22, 2006. The Company valued the warrants using the Black-Scholes option pricing model (key assumptions: risk free interest rate: 3.75%, volatility 85%, expected life 2 years, zero dividend yield). The total value of \$502,500 was capitalized and classified as prepaid inventory. During 2004 the Company reclassified the prepaid inventory when inventory was purchased as a component of the inventory cost. As of December 31, 2004 approximately \$251,000 of this asset remained on the balance sheet and was included in other current assets.

WARRANTS ISSUED TO INVESTORS

In accordance with EITF 00-19, the Company accounted for the 385,801 warrants issued in connection with the January 2004 Financing at fair market value and classified the warrants as a liability because the Company may have been required to make cash payments to the investors who purchased the warrants in the event that the registration statement covering the offer and sale of the shares underlying the warrants were to no longer be effective. The Company used the Black-Scholes option pricing method (assumption: volatility 147%, risk free rate 3.76% two year expected life and zero dividend yield) to calculate the value of the warrants. At January 12, 2004, the date of transaction (the "Transaction Date"), the warrants had a value of \$1,096,000. The value of the warrants was marked to market in each subsequent reporting period as a derivative gain or loss until June 17, 2004 (the "End Date"), at which time EITF 00-19 called for the warrants to be re-classified as equity because the maximum potential cash amount payable to the investors had decreased to the point where it was no longer considered significant.

F-19

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

During the period beginning on the Transaction Date and ending on the End Date, the value of the warrants decreased from \$1,096,000 to \$532,000, and, accordingly the Company recognized \$564,000 of other income for the year ended December 31, 2004.

Edgar Filing: BLUEFLY INC - Form 10-K

The following table represents warrants issued to purchase Common Stock as of December 31, 2004:

PARTY	NUMBER OF WARRANTS	EXERCISE PRICE RANGE	EXPIRATION DATES
Investor	385,801	\$3.96	January 2009
Soros	981,644	\$0.78 - \$9.08	January 2007 - March 2013
Supplier	300,000	\$2.34 - \$3.72	September 2005 - December 2006
Others	37,500	\$1.34	March 2006
	----- 1,704,945 =====		

STOCK OPTION PLAN

The Company's Board of Directors has adopted two stock option plans, one in July 2000 (the "2000 Plan") and the other in May 1997 (the "1997 Plan"). The Plans were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company. Options are granted in terms not to exceed ten years and become exercisable as specified when the option is granted. Vesting terms of the options range from immediately to a ratable vesting period of four years. The 2000 Plan has 1,500,000 shares authorized for issuance. During 2004, the Company amended the 1997 Plan in order to increase the maximum number of shares that may be granted under the Plan to 14,200,000.

F-20

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

The following table summarizes the Company's stock option activity:

	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
BALANCE AT JANUARY 1, 2002	4,343,203	\$ 4.28
Options granted	5,239,000	\$ 0.94
Options canceled	(1,073,791)	\$ 5.26
Options exercised	-	-

BALANCE AT DECEMBER 31, 2002	8,508,412	\$ 2.27
Options granted	2,561,000	\$ 1.34
Options canceled	(705,030)	\$ 3.49
Options exercised	(1,856,012)	\$ 1.59

BALANCE AT DECEMBER 31, 2003	8,508,370	\$ 2.04
Options granted	2,629,750	\$ 2.74
Options canceled	(534,360)	\$ 2.57
Options exercised	(790,381)	\$ 0.95

BALANCE AT DECEMBER 31, 2004	9,813,379	\$ 2.28

Edgar Filing: BLUEFLY INC - Form 10-K

Eligible for exercise at December 31, 2002	3,612,420	\$	3.59
Eligible for exercise at December 31, 2003	4,523,606	\$	1.30
Eligible for exercise at December 31, 2004	6,512,125	\$	2.44

The stock options are exercisable in different periods through 2014. Additional information with respect to the outstanding options as of December 31, 2004, is as follows:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	OPTIONS OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
\$0.69 - \$1.66	5,163,050	5.8 Years	\$ 1.12	3,667,018	\$ 1.05
\$1.66 - \$3.32	3,561,179	5.7 Years	2.58	2,075,390	2.82
\$3.32 - \$4.98	707,000	5.6 Years	3.96	387,567	3.95
\$4.98 - \$6.64	29,750	3.7 Years	5.08	29,750	5.08
\$6.64 - \$9.96	54,750	4.6 Years	9.15	54,750	9.15
\$9.96 - \$11.62	109,500	4.9 Years	11.19	109,500	11.19
\$11.62 - \$13.28	50,000	0.0 Years	12.34	50,000	12.34
\$13.28 - \$14.94	7,250	4.9 Years	14.09	7,250	14.09
\$14.94 - \$16.60	130,900	2.5 Years	15.71	130,900	15.71
\$0.69 - \$16.60	9,813,379	5.7 Years	\$ 2.28	6,512,125	\$ 2.44

The Company does not recognize compensation expense for stock options granted to employees and directors with an exercise price at or above fair market value at the date of the grant, in accordance with APB No.25. The fair value of options granted during 2004, 2003 and 2002 was approximately \$6.8 million, \$2.9 million and \$4.0 million, respectively. The Company calculated the fair value of each option grant on the date of the grant using the Black-Scholes option pricing model as prescribed by SFAS No. 123.

F-21

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

The following assumptions were used in applying the model:

	YEAR ENDED DECEMBER 31,		
	2004	2003	2002
Risk-free interest rates	3.63%	3.59%	4.38%
Expected life (in years)	6	6	6
Dividend yield	0%	0%	0%
Expected volatility	139%	113%	164%

As of December 31, 2004, the Company has reserved an aggregate of 54,841,754 shares of Common Stock for the conversion of Preferred Stock and the exercise of Stock Options and Warrants.

Edgar Filing: BLUEFLY INC - Form 10-K

10. NOTES PAYABLE TO RELATED PARTY SHAREHOLDERS

In addition to the \$4,000,000 of promissory notes issued in connection with the July 2003 Financing and October 2003 Financing (see Note 9 above), on December 15, 2001, the Company issued promissory notes in the amount of \$182,000 to affiliates of Soros in exchange for legal services provided during the course of the year. The notes bore interest at 9% per annum and had a maturity date of December 15, 2004. In December 2004 the Company repaid the notes with accrued interest of \$54,000 for a total of \$236,000.

In January 2004, the Company also extended the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003 (the "Notes"). The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended to March 1, 2005. In February 2005, the maturity date of the Notes was further extended to May 1, 2006.

11. FINANCING AGREEMENT

The Company has a financing agreement (the "Financing Agreement") with Rosenthal & Rosenthal, Inc. ("Rosenthal") pursuant to which Rosenthal provides the Company with certain credit accommodations, including loans and advances, factor-to-factor guarantees or letters of credit in favor of suppliers or factors or purchases of payables owed to the Company's suppliers (the "Loan Facility").

The Financing Agreement was amended in April 2004 and then again in February 2005 to: (i) extend the term until March 30, 2006; (ii) substitute \$1.25 million of cash collateral pledged by the Company for the \$2.0 million standby letter of credit previously provided by Soros as collateral security for the Company's obligations under the Loan Facility; (iii) decrease the maximum amount available under the Loan Facility from \$4.5 million to \$4.0 million; (iv) increase the tangible net worth requirement to \$7.0 million; (v) increase the working capital requirement to \$6.0 million; and (vi) increase the minimum cash balance that the Company is required to maintain to \$750,000 (exclusive of the \$1.25 million in cash collateral). The cash collateral is included on the balance sheet as "Restricted Cash" and represents monies deposited in a segregated account that has been pledged to Rosenthal as collateral for the facility. During fiscal 2004, the maximum amount available under the Loan Facility did not exceed \$3.5 million.

F-22

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

Because the requirement that Soros provide a standby letter of credit to secure the Loan Facility was removed, the Company is no longer subject to an agreement with Soros that previously required it to issue additional warrants to Soros with an exercise price equal to 75% of market price in the event that Rosenthal were to draw on Soros' letter of credit.

As of December 31, 2004, the maximum availability under the Loan Facility was approximately \$3.5 million of which approximately \$2.3 million was committed, leaving approximately \$1.2 million available

Edgar Filing: BLUEFLY INC - Form 10-K

against the Loan Facility.

The Company pays interest monthly on the average daily amount outstanding under the Loan Facility during the preceding month at a per annum rate equal to the prime rate plus 1% (at December 31, 2004 - 6.25%). For the period ended December 31, 2004, 2003 and 2002 interest expense and fees totaled approximately \$112,000, \$77,000 and \$91,000, respectively.

The Company pays an annual facility fee equal to 1.5% of the portion of the Loan Facility that is provided on the basis of its inventory level. This formula currently results in an annual facility fee of \$33,750. Rosenthal also charges 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.

In consideration for the Loan Facility, among other things, we granted to Rosenthal a first priority lien on substantially all of our assets, including control of all of our cash accounts (including the \$1.25 million of cash collateral, which has been placed in a segregated, restricted account) upon an event of default and certain of our cash accounts in the event that the total amount of funded debt loaned to us under the Loan Facility exceeds 90% of the maximum amount available under the Loan Facility for more than 10 days.

Under the terms of the Loan Facility, Soros has the right to purchase all of our obligations from Rosenthal at any time during its term.

ROSENTHAL WARRANTS

Upon inception of the Loan Facility in March 2001, the Company issued to Rosenthal a warrant to purchase 50,000 shares of Common Stock at an exercise price of \$2.34, per share exercisable for five years. The Company valued the warrant using the Black-Scholes option pricing model (key assumptions: risk free interest rate: 4.86%, volatility 117%, expected life 4 years, zero dividend yield) and amortized the fair value of the warrants of \$45,000 amount over the life of the Loan Facility. In March 2002, when the agreement was amended and as partial consideration for the amendment, the Company extended the termination date of the warrant it issued to Rosenthal from March 30, 2006 to March 30, 2007. The Company revalued the warrant as of the new measurement date, using the Black-Scholes option pricing model (key assumptions: risk free interest rate: 5.25%, volatility 184%, expected life 3 years, zero dividend yield) and credited additional paid in capital for \$80,000. This amount was amortized in full in fiscal 2002.

In November 2003, Rosenthal exercised this warrant in full.

SOROS WARRANTS IN CONNECTION WITH LOAN FACILITY

Prior to April 2004, Soros guaranteed repayment of the Loan Facility (the "Soros Guarantee"). The Company issued warrants to Soros in consideration for the establishment and continuance of the Soros Guarantee as described below.

F-23

Edgar Filing: BLUEFLY INC - Form 10-K

The following table represents the warrants issued to Soros in connection with the Loan Facility:

Number of Warrants	Date Issued	Exercise Price	Expiration Date	Assumptions Under Black-Scholes	Reason
100,000	March 31, 2001	\$ 0.88 (1)	September 11, 2011	Risk Free Rate - 4.86% Volatility - 117% Term - 5 years	As considered for S establish Soros Gu
60,000	March 22, 2002	\$ 1.66 (1)	March 22, 2007	Risk Free Rate - 5.25% Volatility - 184% Term - 3 years	In considered for S extendi Soros Gu until 11/
25,000	March 17, 2003	\$ 0.78 (2)	March 17, 2013	Risk Free Rate - 3.31% Volatility - 123% Term - 4 years	In considered for So extendin Soros Gua until 11/

(1) represents the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance

(2) represents the 10 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance

The Company accounted for the warrants in accordance with Accounting Principles Board Opinion No. 14 ("APB No. 14") by valuing the warrants using the Black-Scholes option pricing model and crediting additional paid in capital for \$74,000, \$98,000 and \$21,000, during the years 2001, 2002 and 2003, respectively. These amounts were amortized to interest expense over the life of the Loan Facility.

F-24

BLUEFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

12. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Amounts in thousands, except per share data:

	QUARTER ENDED		
	MARCH 31	JUNE 30	SEPTEMBER 30
2004			
Net Sales	\$ 11,114	\$ 9,495	\$ 8,000
Gross Profit	\$ 3,782	\$ 3,807	\$ 2,000

Edgar Filing: BLUEFLY INC - Form 10-K

Net Income (Loss)	\$ (1,130)	\$ (708)	\$ (1,130)
Preferred stock dividends	\$ (1,024)	\$ (1,062)	\$ (1,024)
Net loss available to common shareholders	\$ (2,154)	\$ (1,770)	\$ (2,154)
(Loss) per common share - basic and diluted	\$ (0.15)	\$ (0.12)	\$ (0.15)

2003	QUARTER ENDED		
	MARCH 31	JUNE 30	SEPTEMBER 30
Net Sales	\$ 8,257	\$ 7,468	\$ 8,257
Gross Profit	\$ 1,857	\$ 2,315	\$ 1,857
Net Income (Loss)	\$ (1,840)	\$ (2,123)	\$ (1,840)
Deemed dividend related to beneficial conversion feature on Series B and C Preferred Stock	\$ (225)	\$ -	\$ (225)
Preferred stock dividends	\$ (638)	\$ (845)	\$ (638)
Net loss available to common shareholders	\$ (2,703)	\$ (2,968)	\$ (2,703)
(Loss) per common share - basic and diluted	\$ (0.25)	\$ (0.27)	\$ (0.25)

13. RELATED PARTY TRANSACTIONS

In August 2004, the Company entered into a Separation Agreement with its former Chief Executive Officer in connection with his resignation. Under the terms of the agreement, he agreed to remain employed by the Company in a non-executive capacity through November 30, 2004 (the "Termination Date") at his then-current salary and to extend the period of the non-competition and non-solicitation covenants contained in his employment agreement from one year to two years after the Termination Date. In consideration for these agreements, the Company, among other things, agreed to (i) to make salary continuation payments equal his salary until June 30, 2005, (ii) to continue to provide his then-current employee benefits for a period of one year following the Termination Date, and (iii) to issue him an option to purchase 100,000 shares of Common Stock at an exercise price equal to the fair market value of the Common Stock on the date of grant and (iv) that all outstanding stock options held by him would vest upon the Termination Date. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 3.88%, volatility 137%, expected life 1 year, zero dividend yield, and charged \$113,000 for the options and \$212,000 related to severance and benefits to general and administrative expense in the third quarter of 2004.

In December 2003, the Company retained a former Executive Vice President of the Company as a consultant. For the year ended December 31, 2004, payments made to the individual were \$58,000.

Edgar Filing: BLUEFLY INC - Form 10-K

F-25

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
FOR THE THREE YEARS ENDED DECEMBER 31, 2004

Column A	Column B	Column C		Column D
-----	-----	(1)	(2)	-----
-----	-----	-----	-----	-----
Description	Beginning Balance at January 1, 2004	Charged to Costs and Expenses	Charged to other Accounts	De
-----	-----	-----	-----	-----
Allowance for Sales Returns	(2,528,000)	(24,366,000)	-	24
Allowance for Doubtful Accounts	(40,000)	(237,000)	-	
Inventory Reserves	(673,000)	(100,000)	-	
Deferred Tax Valuation Allowance	(26,872,000)	(1,518,000)	(348,000)	

Column A	Column B	Column C		Column D
-----	-----	(1)	(2)	-----
-----	-----	-----	-----	-----
Description	Beginning Balance at January 1, 2003	Charged to Costs and Expenses	Charged to other Accounts	De
-----	-----	-----	-----	-----
Allowance for Sales Returns	(1,725,000)	(21,589,000)	-	20
Allowance for Doubtful Accounts	(50,000)	(131,000)	-	
Inventory Reserves	(560,000)	(440,000)	-	
Deferred Tax Valuation Allowance	(22,501,000)	(2,299,000)	(2,072,000)	

Column A	Column B	Column C		Column D
-----	-----	(1)	(2)	-----
-----	-----	-----	-----	-----
Description	Beginning Balance at January 1, 2002	Charged to Costs and Expenses	Charged to other Accounts	De
-----	-----	-----	-----	-----
Allowance for Sales Returns	(1,375,000)	(16,265,000)	-	15
Allowance for Doubtful Accounts	(55,000)	(241,000)	-	
Inventory Reserves	(455,000)	(113,000)	-	
Deferred Tax Valuation Allowance	(19,707,000)	(2,794,000)	-	

Edgar Filing: BLUEFLY INC - Form 10-K

S-1

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9a. CONTROLS AND PROCEDURES

As of the end of the period covered by this Form 10-K, 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 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.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers and directors, and their ages and positions are as follows:

NAME	AGE	POSITION
Alan Kane	63	Chairman of the Board of Directors
Melissa Payner-Gregor	46	Chief Executive Officer and President
Patrick C. Barry	42	Chief Financial Officer and Chief Operating Officer
Barry Erdos	60	Director
Monica Halpert	45	Chief Marketing Officer
Martin Keane	40	Senior Vice President of E-Commerce
Christopher G. McCann	44	Director
Martin Miller	74	Director
Neal Moszkowski	39	Director
David Wassong	34	Director

Alan Kane has served as a director since August 2002 and became Chairman of the Board in August 2004. Since September 1997, Mr. Kane has been the professor of retailing at the Columbia University Graduate School of Business. Before joining the Columbia Business School, Mr. Kane spent 28 years in the retailing industry. His experience in the retailing industry includes the following: President and Chief Executive Officer of Grossman's Eastern Division, a building materials retailer, from 1993 to 1994, President and Chief Executive Officer of Pergament Home Centers, a home center retailer, from 1991 to 1993, Private Consultant in the retailing industry from 1987 to 1991, and President and Chief Executive Officer of Hahne & Company, a department store chain and division of May Company, from 1979 to 1987. He has also served as a member of the Board of Directors of Circuit City Stores, Inc. an electronics retailer, since 2003.

Edgar Filing: BLUEFLY INC - Form 10-K

Melissa Payner-Gregor, has served as our President since September 2003 and became Chief Executive Officer in August 2004. From December 2000 to March 2003, Ms. Payner-Gregor served as CEO and President of Spiegel Catalog. She was also a board member of The Spiegel Group, Inc. ("Spiegel") from December 2000 to March 2003. From 1997 to 2000, Ms. Payner-Gregor was the Senior Vice President of Merchandising and Advertising of Spiegel. Spiegel filed a plan of reorganization under Chapter 11 of the Federal Bankruptcy code in March 2003. From 1995 to 1997, Ms. Payner-Gregor was President and a board

26

member of Chico FAS, Inc. Ms. Payner-Gregor has also held senior executive positions with Guess?, Inc., Pastille (a Division of Neiman Marcus) and Henri Bendel.

Patrick C. Barry served as an Executive Vice President from July 1998 to September 2000 and has been our Chief Financial Officer since August 1998. In September 2000, Mr. Barry assumed the role of Chief Operating Officer and has served us in that capacity since such time. From June 1996 to July 1998, Mr. Barry served as the Chief Financial Officer and the Vice President of Operations of Audible, Inc., an Internet commerce and content provider. From March 1995 to June 1996, Mr. Barry was the Chief Financial Officer of Warner Music Enterprises, a direct marketing subsidiary of Time Warner, Inc. From July 1993 to March 1995, Mr. Barry served as Controller of Book-of-the-Month Club, a direct marketing subsidiary of Time Warner, Inc.

Barry Erdos has served as a director since February 2005. Since April 2004, Mr. Erdos has served as President and Chief Operating Officer of Build a Bear Workshop, Inc., a specialty retailer of plush animals and related products. Mr. Erdos was the Chief Operating Officer and a director of Ann Taylor Stores Corporation and Ann Taylor Inc., a women's apparel retailer, from November 2001 to April 2004. He was Executive Vice President, Chief Financial Officer and Treasurer of Ann Taylor Stores Corporation and Ann Taylor Inc. from 1999 to 2001. Prior to that, he was Chief Operating Officer of J. Crew Group, Inc., a specialty retailer of apparel, shoes and accessories, from 1998 to 1999.

Monica Halpert has served as our Chief Marketing Officer since October 2004. Ms. Halpert has over 20 years of experience in marketing and brand building. Since September 2001, she has worked as an independent branding and marketing consultant for a number of clients, including AOL, ABC Family, USA cable and News Corporation. From October 1998 to September 2001, Ms. Halpert was a Senior Vice President and Creative Director of VH1.

Martin Keane served as Vice President of Product Development and E-Commerce from January 1999 through September 2004 when he assumed the role of Senior Vice President of E-Commerce. From 1997 to 1999, Mr. Keane was the Design Director for Music Boulevard, an E-Commerce site owned by N2K, Inc. From 1990 to 1997, Mr. Keane served as Regional Manager for APCO Graphics, an architectural graphics company.

Christopher G. McCann has served as a director since February 2005. Since September 2000, Mr. McCann has been the President of 1-800-flowers, a leading retailer of floral products and other gifts, and prior to that was that company's Senior Vice President. Mr. McCann has been a Director of 1-800-flowers since inception. Mr. McCann serves on the board of directors of Neoware, Inc., a provider of software, services and solutions to enable thin client appliance computing, and is a member of the Board of Trustees of the Marist College.

Martin Miller has served as a director since July 1991. Since July 1999, Mr. Miller has served as the President of The Terbell Group, Inc., a consulting company. From October 1997 to April 2003, Mr. Miller has been a partner in the

Edgar Filing: BLUEFLY INC - Form 10-K

Belvedere Fund, L.P., a fund of hedge funds.

Neal Moszkowski has served as a director since August 1999 and is the Series A Preferred Stock designee. Mr. Moszkowski is the co-head of Soros Private Equity, the private equity investment business of Soros Fund Management LLC ("Soros Private Equity") and has been a partner of Soros Private Equity since August 1998. Prior to joining Soros Private Equity, Mr. Moszkowski was an Executive Director of Goldman Sachs International and a Vice President of Goldman, Sachs & Co., an investment banking firm, in its Principal Investment Area. He joined Goldman, Sachs & Co. in August 1993. Mr. Moszkowski is also a Director of Integra Life Sciences Holdings, Inc., a medical products company, Wellcare Health Plans, Inc., a managed care services provider and Jet Blue Airways Corporation, a low fare airline.

David Wassong has served as a director since February 2001 and is the Series B Preferred Stock designee. Mr. Wassong has been a partner of Soros Private Equity since June 1998. Prior to joining Soros Private Equity, from July 1997 to June 1998, Mr. Wassong was Vice President, and previously Associate, at Lauder Gaspar Ventures, LLC, a media, entertainment and telecommunications-focused venture capital fund.

CORPORATE GOVERNANCE

Our Board of Directors has reviewed the independence of each of our directors on the basis of the standards adopted by Nasdaq. In this review, the Board considered transactions and relationships between us, on the one hand, and each director, members of his or her immediate family, and other entities with which he or she is affiliated, on the other hand. As a result of this review, the Board of Directors affirmatively determined that Messrs. Miller, Kane, Erdos and McCann are each "independent directors"

27

within the meaning of the Nasdaq rules. Because Soros owns a majority of the voting power of our capital stock, the Board determined that it was appropriate for us to rely upon the "Controlled Company" exemption provided by Nasdaq rules. Accordingly, Nasdaq rules do not require that a majority of our Board of Directors be independent, and, similarly, do not require that all of the members of the Nominating Committee (as defined below) be independent.

The Board of Directors has established an Audit Committee ("Audit Committee") in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Audit Committee is comprised of Barry Erdos, Chris McCann, Alan Kane and Martin Miller. Mr. Erdos is the Chairman of the Audit Committee. The Audit Committee is responsible for the appointment of our outside accountants, examining the results of audits, reviewing internal accounting controls and reviewing related party transactions. The Board has determined that Mr. Erdos is an "audit committee financial expert" within the meaning of the Securities and Exchange Commission's rules and that each member of the Audit Committee is "independent," as that term is used in Item 7(d)(3)(iv) of Schedule 14A promulgated under the Exchange Act.

The Board of Directors also has established an Option Plan/Compensation Committee ("Option Plan/Compensation Committee") consisting of Neal Moszkowski and Martin Miller. The Option Plan/Compensation Committee administers the Company's 1997 and 2000 Stock Option Plans, establishes the compensation levels for executive officers and key personnel and oversees the Company's bonus plans.

In June 2004, the Board of Directors established a Nominating and Governance Committee ("Nominating Committee"), consisting of Alan Kane and David Wassong. Mr. Kane is an independent director under Nasdaq rules. While Mr. Wassong is not

Edgar Filing: BLUEFLY INC - Form 10-K

an independent director under Nasdaq rules, he is permitted to sit on the Nominating Committee pursuant to the "Controlled Company" exemption discussed above. The purposes of the Nominating Committee are to assist the Board of Directors by identifying individuals qualified to become directors, and setting criteria for, and evaluating, candidates for director nominees, and to recommend to the Board of Directors the director nominees for election at the annual meetings of stockholders or for appointments to fill vacancies; recommend to the Board of Directors nominees for each committee of the Board; advise the Board of Directors about appropriate composition of the Board and its committees; advise the Board of Directors about and recommend to the Board of Directors appropriate corporate governance practices and to assist the Board of Directors in implementing those practices; lead the Board of Directors in its annual review of the performance of the Board and its committees; and perform such other functions as the Board of Directors may assign to it from time to time.

We have adopted a Code of Ethics applicable to all directors, officers and employees, which meets the requirements of a "code of ethics" as defined in Item 406 of Regulation S-K, and we maintain procedures for the confidential, anonymous submission by employees of complaints regarding our accounting, internal accounting controls, auditing matters and other issues. A copy of our code of ethics is available on the Company's Web site at www.bluefly.com. Any amendment to or waiver of a provision of the code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer, controller or persons performing similar functions and relates to elements of the code specified in the rules of the Securities and Exchange Commission will be posted on the Web site.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our directors and executive officers and persons who beneficially own more than ten percent of our Common Stock (collectively, the "Reporting Persons") to file with the Securities and Exchange Commission initial reports of beneficial ownership and reports of changes in beneficial ownership of the Common Stock. Reporting Persons are required to furnish us with copies of all such reports. E. Kenneth Seiff, our former Chief Executive Officer, was late in filing two Form 4's. Both Form 4's were filed five business days after the first transaction included therein. To our knowledge, based solely on a review of copies of such reports furnished to us, we believe that during the 2004 fiscal year all Reporting Persons complied with all applicable Section 16(a) reporting requirements except as noted above.

ITEM 11. EXECUTIVE COMPENSATION

COMPENSATION OF DIRECTORS

Our independent, outside non-employee directors are paid a cash stipend of \$1,500 for each board or committee meeting attended in person (and, in the case of the Audit Committee Chairman, \$2,000 per meeting) and are reimbursed for expenses incurred on our behalf. In addition, each such director is paid an annual retainer of \$10,000 at the first regularly scheduled

28

Board meeting of each fiscal year. The maximum aggregate stipend and retainer paid to any such director in a year is \$16,000 (or, in the case of the Audit Committee Chairman, \$18,000).

Each non-employee director receives an option to purchase 15,000 shares of Common Stock (25,000 shares in the case of the Chairman of the Board and 20,000 shares in the case of the Chairman of the Audit Committee) at the time of the first regularly scheduled Board meeting after such director is appointed to the

Edgar Filing: BLUEFLY INC - Form 10-K

Board and an annual grant of an option to purchase 10,000 shares of Common Stock (20,000 shares in the case of the Chairman of the Board and 12,500 shares in the case of the Chairman of the Audit Committee) at the first regularly scheduled Board meeting of each fiscal year (even if such director is receiving an option in connection with his or her appointment at such meeting).

COMPENSATION OF EXECUTIVE OFFICERS

The following table sets forth information concerning the compensation paid by us during the fiscal years ended December 31, 2004, 2003 and 2002 to our Chief Executive Officer, our former Chief Executive Officer and our two other executive officers who received total compensation from us in excess of \$100,000 in the year 2004 (the "Named Executive Officers").

NAME AND PRINCIPAL POSITION	YEAR	ANNUAL COMPENSATION		
		SALARY	BONUS	OTHER ANNUAL COMPENSATION
Melissa Payner-Gregor	2004	\$ 466,960	\$ 115,000	\$ 655
Chief Executive Officer and President	2003	\$ 112,500	--	\$ --
E. Kenneth Seiff/(1)/	2004	\$ 222,116/(6)/	--	\$ 2,926
Former Chief Executive Officer	2003	\$ 274,999	\$ 75,000	\$ 2,926
	2002	\$ 274,999	\$ 50,000/(4)/	\$ 3,782
Patrick C. Barry	2004	\$ 260,429	\$ 80,000	\$ 590
Chief Financial Officer and Chief	2003	\$ 225,000	--	\$ 590
Operating Officer	2002	\$ 224,999	\$ 35,000/(4)/	\$ 590
Martin Keane	2004	\$ 171,538	\$ 20,000/(5)/	\$ --
Senior Vice President of E-Commerce	2003	\$ 152,308	\$ 30,500	\$ --
	2002	\$ 150,000	\$ 12,500	\$ --

/(1)/ Mr. Seiff resigned as an executive officer of the Company in August 2004.

/(2)/ Options granted at an exercise price equal to 100% of the fair market value on the date of grant.

/(3)/ Options granted at an exercise price equal to 100% of the fair market value on the date of grant, except for 100,000 options that, pursuant to Ms. Payner-Gregor's employment agreement, were granted at an exercise price of \$1.56 (the fair market value of the Common Stock on the date of Ms. Payner-Gregor's employment agreement). The fair market value of the common stock on the date of grant of such options was \$2.49 per share.

/(4)/ Represents amounts earned in 2002, but paid in fiscal 2003.

/(5)/ Represents amounts earned in 2003, but paid in fiscal 2004.

/(6)/ Includes \$31,731 related to severance and excludes \$63,462 related to services provided as a consultant

EMPLOYMENT AGREEMENTS

We currently have employment agreements with Ms. Payner-Gregor and Mr. Barry. Each such employment agreement provides for a base salary, subject to increase by the Compensation Committee, and an annual bonus to be determined by the Compensation Committee. Ms. Payner-Gregor's annual bonus for each fiscal year during her agreement cannot be less than 3% of our net income for such fiscal year, subject to a cap equal to 200% of her base salary. Her bonus is subject to

Edgar Filing: BLUEFLY INC - Form 10-K

a minimum floor of \$100,000. Ms. Payner-Gregor's annual base salary is \$450,000, and Mr. Barry's annual base salary is \$300,000. The employment agreement for Mr. Barry terminates on June 30, 2005, and Ms. Payner-Gregor's terminates on March 1, 2007 (unless both parties fail to provide notice of their desire not to renew such agreement at least 90 days prior to the end of the then-current term of such agreement in which case the employment agreement shall automatically renew for successive one-year

29

terms)on . Each of these employment agreements obligates the Company to make severance payments equal to six months' salary in connection with a termination by the Company of such Named Executive Officer's employment, other than for cause, and also provides for the immediate vesting of any stock options held by them under such circumstances. Ms. Payner-Gregor's and Mr. Barry's employment agreements also provide for the immediate vesting of any stock options held by such Named Executive Officer upon the occurrence of certain events classified as a "Change In Control". In addition, Ms. Payner-Gregor's and Mr. Barry's employment agreements provide that upon the occurrence of certain events classified as a "Change of Control" in which cash, securities or other consideration is paid or payable, or otherwise to be distributed directly to the Company's stockholders, each such Named Executive shall receive a bonus equal to a percentage of the proceeds received by the Company's stockholders.

OPTION GRANTS IN LAST FISCAL YEAR

The following table contains information concerning the grant of stock options to the Named Executives Officers during the fiscal year ended December 31, 2004:

INDIVIDUAL GRANTS					
NAME	NUMBER OF SECURITIES UNDERLYING OPTIONS GRANTED (#)	% OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR (%)	EXERCISE OR BASE PRICE (\$)	EXPIRATION DATE	
Melissa Payner-Gregor	100,000/(1)/	3.88%	\$ 1.56	5/24/2014	
	100,000	3.88%	\$ 2.49	5/24/2014	
	500,000	19.41%	\$ 2.08	8/26/2014	
E. Kenneth Seiff/(2)/	300,000	11.65%	\$ 3.95	11/30/2005	
	100,000	3.88%	\$ 2.08	11/30/2005	
Patrick C. Barry	300,000	11.65%	\$ 2.08	8/26/2014	

/(1)/ Pursuant to Ms. Payner-Gregor's employment agreement this option was granted at an exercise price equal to the fair market value on the date of the employment agreement. The fair market value on the date of grant was \$2.49 per share.

/(2)/ Mr. Seiff resigned as an executive officer of the Company in August 2004.

The Company does not currently grant stock appreciation rights.

OPTION HOLDINGS

The following table sets forth information with respect to the Named Executive

Edgar Filing: BLUEFLY INC - Form 10-K

Officers concerning the number and value of unexercised options held at December 31, 2004.

NAME	SHARES ACQUIRED ON EXERCISE #	VALUE REALIZED \$	SECURITIES UNDERLYING UNEXERCISED OPTIONS AT DECEMBER 31, 2004 (#)	
			EXERCISABLE	UNEXERCISABLE
E. Kenneth Seiff/(2)/ Melissa Payner-Gregor	551,623	\$ 779,553	2,953,377/(3)/	--
Patrick C. Barry	--	--	609,040	1,290,960
Martin Keane	--	--	1,436,496	250,081
			300,200	99,780

/(1)/ Represents the value of unexercised, in-the-money stock options at December 31, 2004, using the \$2.32 closing price of the Common Stock on that date.

/(2)/ Mr. Seiff resigned as an executive officer of the Company in August 2004.

/(3)/ On January 11, 2005, 1,105,000 of these options expired.

30

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

COMMON STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Common Stock of the Company as of February 18, 2005, for (i) each person who is known by the Company to own beneficially more than 5% of the Common Stock, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

NAME/(1)/	NUMBER OF SHARES BENEFICIALLY OWNED
Patrick C. Barry	1,528,985/(3)/
Barry Erdos	--
Alan Kane	7,500/(4)/
Martin Keane	325,240/(5)/
Martin Miller	31,250/(6)//(7)/
Neal Moszkowski/(8)/	18,750/(9)/
Christopher G. McCann	--
Melissa Payner-Gregor	767,467/(10)/
E. Kenneth Seiff/(11)/	2,147,800/(12)//(13)/
David Wassong/(8)/	11,250/(14)/
SFM Domestic Investments LLC	1,576,833/(15)//(19)/
Quantum Industrial Partners LDC	48,188,318/(16)//(19)/
George Soros	49,765,151/(17)//(19)/
All directors and executive officers as a group (10 persons)	2,926,631/(18)/

* Less than 1%.

Edgar Filing: BLUEFLY INC - Form 10-K

- / (1) / Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- / (2) / Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- / (3) / Includes 1,523,985 shares of Common Stock issuable upon exercise of options granted under the Plan.
- / (4) / Includes 7,500 shares of Common Stock issuable upon exercise of options granted under the Plan.
- / (5) / Includes 325,240 shares of Common Stock issuable upon exercise of options granted under the Plan.
- / (6) / Includes 28,250 shares of Common Stock issuable upon exercise of options granted under the Plan.
- / (7) / Includes 3,000 shares of Common Stock held by Madge Miller, the wife of Martin Miller, as to which Mr. Miller disclaims beneficial ownership.
- / (8) / Messrs. Moszkowski and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock, respectively. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the

31

- shares of Common Stock beneficially owned by George Soros, SFMDI and QIP (as defined in notes (15) and (16) below) and none of such shares are included in the table above as being beneficially owned by them.
- / (9) / Includes 18,750 shares of Common Stock issuable upon exercise of options granted under the Plan.
 - / (10) / Includes 767,467 shares of Common Stock issuable upon exercise of options granted under the Plan.
 - / (11) / Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.
 - / (12) / Includes 3,000 shares of Common Stock held by Nicole Seiff, the wife of E. Kenneth Seiff, as to which Mr. Seiff disclaims beneficial ownership.
 - / (13) / Includes 1,848,377 shares of Common Stock issuable upon exercise of options.
 - / (14) / Includes 11,250 shares of Common Stock issuable upon exercise of options.
 - / (15) / Represents: 124,700 shares of Common Stock issuable upon conversion of 14,590 shares of Series A Preferred Stock; 866,942 shares of Common Stock issuable upon conversion of 281,571 shares of Series B Preferred Stock; 41,710 shares of Common Stock issuable upon conversion of 31.7 shares of Series C Preferred Stock; 297,669 shares of Common Stock issuable upon conversion of 226.229 shares of Series D Preferred Stock; 41,710 shares of Common Stock issuable upon conversion of 31.7 shares of Series E Preferred Stock; 172,995 shares of Common Stock; 31,107 shares of Common Stock issuable upon exercise of warrants (collectively, the "SFMDI Shares") held in the name of SFM Domestic Investments LLC ("SFMDI"). SFMDI is a Delaware limited liability company. As sole managing member of SFMDI, George Soros ("Mr. Soros") may also be deemed the beneficial owner of the SFMDI Shares. The principal address of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
 - / (16) / Represents: 3,806,923 shares of Common Stock issuable upon conversion of

Edgar Filing: BLUEFLY INC - Form 10-K

445,410 shares Series A Preferred Stock; 26,503,095 shares of Common Stock issuable upon conversion of 8,607,843 shares of Series B Preferred Stock; 1,274,078 shares of Common Stock issuable upon conversion of 968.3 shares of Series C Preferred Stock; 9,092,525 shares of Common Stock issuable upon conversion of 6,910.319 shares of Series D Preferred Stock; 1,274,078 shares of Common Stock issuable upon conversion of 968.3 shares of Series E Preferred Stock; 5,287,082 shares of Common Stock; 950,537 shares of Common Stock issuable upon exercise of warrants (collectively, the "QIP Shares") held in the name of Quantum Industrial Partners LDC ("QIP"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands. QIH Management Investor, L.P. ("QIHMI"), an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management LLC, a Delaware limited liability company ("QIH Management"). Soros Fund Management LLC, a Delaware limited liability company ("SFM"), is the sole managing member of QIH Management. QIP is a Cayman Islands limited duration company with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. Mr. Soros is the sole shareholder of QIH Management, and has entered into an agreement with SFM, pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros, as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP Shares. Accordingly, each of QIP, QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be the beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

- /(17)/ See (15) and (16) above
- /(18)/ Includes 2,885,692 shares of Common Stock issuable upon exercise of options.
- /(19)/ See "Risk Factors - Soros Owns a Majority of Our Stock."

SERIES A PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series A Preferred Stock of the Company as of February 18, 2005, for (i) each person who is known by the Company to own beneficially more than 5% of the Series A Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

NAME/(1)/	NUMBER OF SHARES BENEFICIALLY OWNED	PER
-----	-----	-----
Patrick C. Barry	-	
Barry Erdos	-	
Alan Kane	-	
Martin Keane	-	
Martin Miller	-	
Neal Moszkowski/(3)/	-	
Christopher G. McCann	-	
Melissa Payner-Gregor	-	

Edgar Filing: BLUEFLY INC - Form 10-K

E. Kenneth Seiff/(7)/	-
David Wassong/(3)/	-
Quantum Industrial Partners LDC	445,410/(4)/(6)/
George Soros	460,000/(5)/(6)/
All directors and executive officers as a group (10 persons)	-

 * Less than 1%.

- /(1)/ Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- /(2)/ Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- /(3)/ Messrs. Moszkowski's and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the Series A Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- /(4)/ Represents the shares of Series A Preferred Stock held in the name of QIP (the "QIP A Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyan 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, the sole shareholder of QIH Management, has entered into an agreement with SFM, pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros, as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP A Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- /(5)/ Represents both (i) 14,590 shares of Series A Preferred Stock held in the name of SFMDI (the "SFMDI A Shares") and (ii) the QIP A Shares referenced in Note 4 above. As sole managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI A Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- /(6)/ See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."
- /(7)/ Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.

Edgar Filing: BLUEFLY INC - Form 10-K

The following table sets forth certain information with respect to the beneficial ownership of the Series B Preferred Stock of the Company as of February 18, 2005, for (i) each person who is known by the Company to own beneficially more than 5% of the Series B Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

NAME / (1) /	NUMBER OF SHARES BENEFICIALLY OWNED	PER
Patrick C. Barry	-	
Barry Erdos	-	
Alan Kane	-	
Martin Keane	-	
Martin Miller	-	
Neal Moszkowski / (3) /	-	
Christopher G. McCann	-	
Melissa Payner-Gregor	-	
E. Kenneth Seiff / (7) /	-	
David Wassong / (3) /	-	
Quantum Industrial Partners LDC	8,607,843 / (4) // (6) /	
George Soros	8,889,414 / (5) // (6) /	
All directors and executive officers as a group (10 persons)	-	

* Less than 1%.

- /(1)/ Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- /(2)/ Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- /(3)/ Messrs. Moszkowski's and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series B Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- /(4)/ Represents the shares of Series B Preferred Stock held in the name of QIP (the "QIP B Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, the sole shareholder of QIH Management, has entered into an agreement with SFM pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros, as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP

Edgar Filing: BLUEFLY INC - Form 10-K

B Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

- /(5)/ Represents both (i) 281,571 shares of Series B Preferred Stock held in the name of SFMDI (the "SFMDI B Shares") and (ii) the QIP B Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- /(6)/ See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

34

- /(7)/ Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.

SERIES C PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series C Preferred Stock of the Corporation as of February 18, 2005, for (i) each person who is known by the Corporation to own beneficially more than 5% of the Series C Preferred Stock of the Corporation, (ii) each of the Corporation's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

NAME/(1)/	NUMBER OF SHARES BENEFICIALLY OWNED	PER
Patrick C. Barry	-	
Barry Erdos	-	
Alan Kane	-	
Martin Keane	-	
Martin Miller	-	
Neal Moszkowski/(3)/	-	
Christopher G. McCann	-	
Melissa Payner-Gregor	-	
E. Kenneth Seiff/(7)/	-	
David Wassong/(3)/	-	
Quantum Industrial Partners LDC	968.3/(4)/(6)/	
George Soros	1,000.0/(5)/(6)/	
All directors and executive officers as a group (10 persons)	-	

*Less than 1%.

- /(1)/ Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- /(2)/ Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60

Edgar Filing: BLUEFLY INC - Form 10-K

- days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- /(3)/ Messrs. Moszkowski's and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series C Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- /(4)/ Represents the shares of Series C Preferred Stock held in the name of QIP (the "QIP C Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyan 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, the sole shareholder of QIH Management, has entered into an agreement with SFM, pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros, as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP C Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

35

- /(5)/ Represents both (i) 31.7 shares of Series C Preferred Stock held in the name of SFMDI (the "SFMDI C Shares") and (ii) the QIP C Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI C Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- /(6)/ See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."
- /(7)/ Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.

SERIES D PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series D Preferred Stock of the Company as of February 18, 2005, for (i) each person who is known by the Company to own beneficially more than 5% of the Series D Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

NAME / (1) /	NUMBER OF SHARES BENEFICIALLY OWNED	PER
Patrick C. Barry	-	
Barry Erdos	-	

Edgar Filing: BLUEFLY INC - Form 10-K

Alan Kane	-
Martin Keane	-
Martin Miller	-
Neal Moszkowski/(3)/	-
Christopher G. McCann	-
Melissa Payner-Gregor	-
E. Kenneth Seiff/(7)/	-
David Wassong/(3)/	-
Quantum Industrial Partners LDC	6,910.319/(4)/(6)/
George Soros	7,136.548/(5)/(6)/
All directors and executive officers as a group (10 persons)	-

*Less than 1%.

- /(1)/ Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- /(2)/ Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- /(3)/ Messrs. Moszkowski's and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series D Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- /(4)/ Represents the shares of Series D Preferred Stock held in the name of QIP (the "QIP D Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyan 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, the sole shareholder of QIH Management, has entered into an agreement with SFM, pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros,

36

- /(5)/ as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP D Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- /(5)/ Represents both (i) 226.229 shares of Series D Preferred Stock held in the name of SFMDI (the "SFMDI D Shares") and (ii) the QIP D Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI D Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.

Edgar Filing: BLUEFLY INC - Form 10-K

- /(6)/ See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."
- /(7)/ Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.

SERIES E PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series D Preferred Stock of the Company as of February 18, 2005, for (i) each person who is known by the Company to own beneficially more than 5% of the Series D Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

NAME/(1)/	NUMBER OF SHARES BENEFICIALLY OWNED	PER
Patrick C. Barry	-	
Barry Erdos	-	
Alan Kane	-	
Martin Keane	-	
Martin Miller	-	
Neal Moszkowski/(3)/	-	
Christopher G. McCann	-	
Melissa Payner-Gregor	-	
E. Kenneth Seiff/(7)/	-	
David Wassong/(3)/	-	
Quantum Industrial Partners LDC	968.3/(4)/(6)/	
George Soros	1,000/(5)/(6)/	
All directors and executive officers as a group (10 persons)	-	

*Less than 1%.

- /(1)/ Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- /(2)/ Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- /(3)/ Messrs. Moszkowski's and Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 28th Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series D Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- /(4)/ Represents the shares of Series E Preferred Stock held in the name of QIP (the "QIP E Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9,

Edgar Filing: BLUEFLY INC - Form 10-K

Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, the sole shareholder of QIH Management, has entered into an agreement with SFM pursuant to which Mr. Soros has agreed to use his best efforts to cause QIH Management to act at the direction of SFM. Mr. Soros, as Chairman of SFM, may be deemed to have sole voting power and sole investment power with respect to the QIP E Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

- /(5)/ Represents both (i) 31.7 shares of Series E Preferred Stock held in the name of SFMDI (the "SFMDI E Shares") and (ii) the QIP E Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI E Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- /(6)/ See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."
- /(7)/ Mr. Seiff resigned as an executive officer of the Company in August 2004. Mr. Seiff's address is c/o Seiff Ventures, LLC, 645 Madison Avenue, 20th Floor, New York, New York 10022.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

EXTENSION OF MATURITY DATES OF NOTES

In February 2005, we extended the maturity dates on the Convertible Promissory Notes issued to affiliates of Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended for one year, from May 1, 2005 to May 1, 2006.

TRANSACTIONS WITH SOROS RELATING TO THE LOAN FACILITY

The Rosenthal Financing Agreement was amended in April 2004 to, among other things, substitute \$1.25 million of cash collateral pledged by the Company for the \$2.0 million standby letter of credit previously provided by Soros as collateral security for our obligations under the Loan Facility. Because we removed the requirement that Soros provide a standby letter of credit to secure the Loan Facility, we are no longer subject to an agreement with Soros that previously required us to issue additional warrants to Soros with an exercise price equal to 75% of market price in the event that Rosenthal were to draw on Soros' letter of credit.

REPAYMENT OF NOTES TO SOROS

In December 2004, promissory notes that we issued to Soros in December 2001 became due and were paid. The notes, which had a face value of \$182,000, were repaid with accrued interest of \$54,000 for a total of \$236,000.

OTHER RELATED PARTY TRANSACTIONS

In August 2004, we entered into a Separation Agreement with E. Kenneth Seiff in connection with his resignation as our Chief Executive Officer. Under the terms of the agreement, Mr. Seiff agreed to remain employed by the Company in a

Edgar Filing: BLUEFLY INC - Form 10-K

non-executive capacity through November 30, 2004 (the "Termination Date") at his then-current salary and to extend the period of the non-competition and non-solicitation covenants contained in his employment agreement from one year to two years after the Termination Date. In consideration for these agreements, the Company, among other things, agreed (i) to make salary continuation payments equal to Mr. Seiff's salary until June 30, 2005, (ii) to continue to provide Mr. Seiff's then-current employee benefits for a period of one year following the Termination Date, (iii) to issue Mr. Seiff an option to purchase 100,000 shares of Common Stock at an exercise price equal to the fair market value of the Common Stock on the date of grant; and (iv) that all outstanding stock options held by Mr. Seiff would vest upon the Termination Date. The Company and Mr. Seiff also exchanged releases in connection with the Separation Agreement.

38

In December 2003, Jonathan Morris, a former Executive Vice President of the company, was retained as a consultant. Mr. Morris terminated his consulting agreement with the company effective March 2004. For the year ended December 31, 2004, payments made to Mr. Morris for consulting services provided totaled approximately \$58,000.

We believe that each of the transactions described above was on terms fair to us and our stockholders, and at least as favorable to us as those available from unaffiliated third parties.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

AUDIT FEES

The aggregate fees billed for professional services rendered by Pricewaterhouse Coopers, LLP ("PwC"), our independent registered public accounting firm, for the audit of our consolidated financial statements, including the reviews of our condensed consolidated financial statements included in its quarterly reports on Form 10-Q, for fiscal 2004 and 2003 were approximately \$148,500 and \$100,000, respectively. In addition we paid PwC approximately \$59,000 in connection with professional services rendered to us in connection with the filing of our S-3.

AUDIT RELATED FEES

Other than the fees described under the caption "Audit Fees" above, PwC did not bill any fees for services rendered to us during fiscal 2004 and 2003 for assurance and related services in connection with the audit or review of our consolidated financial statements.

TAX FEES

PwC did not bill us for any professional services rendered to us during fiscal 2004 and 2003 for tax compliance, tax advice or tax planning.

OTHER FEES

PwC did not bill us for any other professional services rendered during fiscal 2004 and 2003 other than those described under the caption "Audit Fees."

AUDIT COMMITTEE PRE-APPROVAL POLICIES

Our policy is that, before PwC is engaged by us to render audit or non-audit services, the engagement is approved by the Audit Committee.

ITEM 15. EXHIBITS

Edgar Filing: BLUEFLY INC - Form 10-K

The following is a list of exhibits filed as part of this Annual Report on Form 10-K:

EXHIBIT NO. -----	DESCRIPTION -----
3.1 (f)	Certificate of Incorporation of the Company.
3.2 (f)	By-Laws of the Company.
3.3 (i)	Certificate of Powers, Designations, Preferences and Rights of Series C Preferred
3.4 (j)	Certificate of Powers, Designations, Preferences and Rights of Series D Preferred
3.5 (k)	Certificate of Powers, Designations, Preferences and Rights of Series E Preferred
10.1 (c)	Amended and Restated 1997 Stock Option Plan.
10.2 (a)	Lease Agreement by and between the Company and John R. Perlman, et al., dated a
10.3 (b)	Investment Agreement among the Company, Quantum Industrial Partners LDC, SFM Do
	39
	LLC and Pilot Capital Corp., dated July 27, 1999.
10.4 (b)	Lease by and between the Company and Adams & Co. Real Estate, Inc., dated March
10.5 (c)	Note and Warrant Purchase Agreement, dated as of March 28, 2000, by and among t Partners LDC and SFM Domestic Investments LLC.
10.6 (d)	Lease by and between the Company and Adams & Co. Real Estate, Inc., dated May 4
10.7 (d)	Note and Warrant Purchase Agreement, dated as of May 16, 2000, by and among the Partners LDC and SFM Domestic Investments LLC.
10.8 (d)	Note and Warrant Purchase Agreement, dated as of June 28, 2000, by and among th Partners LDC and SFM Domestic Investments LLC.
10.9 (e)	Bluefly, Inc. 2000 Stock Option Plan.
*10.10 (e)	Service Agreement by and between the Company and Distribution Associates, Inc.,
10.11 (e)	Note and Warrant Purchase Agreement, dated as of August 21, 2000, by and among Partners LDC and SFM Domestic Investments LLC.
10.12 (e)	Note and Warrant Purchase Agreement, dated as of October 2, 2000, by and among Partners LDC and SFM Domestic Investments LLC.0
10.13 (e)	Investment Agreement, dated November 13, 2000, by and among the Company, Bluefl Industrial Partners LDC and SFM Domestic Investments LLC.
10.14 (f)	Financing Agreement, dated March 30, 2001, between the Company and Rosenthal &
10.15 (f)	Warrant, dated March 30, 2001, issued to Rosenthal & Rosenthal, Inc.

Edgar Filing: BLUEFLY INC - Form 10-K

- 10.16 (f) Warrant, dated March 30, 2001, issued to Quantum Industrial Partners LDC.
 - 10.17 (f) Warrant, dated March 30, 2001, issued to SFM Domestic Investments LLC.
 - 10.18 (g) EBusiness Hosting Agreement, dated January 9, 2002 between the Company and Inte Corporation.
 - *10.19 (g) Software License and Services Agreement, dated March 12, 2002, by and among the Company and Blue Martini Software, Inc.
 - 10.20 (g) Amendment No. 1 to Financing Agreement, dated April 30, 2001, between the Compa Inc.
 - 10.21 (g) Amendment No. 2 to Financing Agreement, dated February 14, 2002 between the Com Inc.
 - 10.22 (g) Amendment No. 3 to Financing Agreement, dated March 22, 2002, between the Compa Inc.
 - 10.23 (g) Amendment to warrant dated March 22, 2002, issued to Rosenthal & Rosenthal, Inc
 - 10.24 (g) Warrant No. 1 dated March 27, 2002, issued to Quantum Industrial Partners LDC.
 - 10.25 (g) Warrant No. 2 dated March 27, 2002, issued to SFM Domestic Investments LLC.
 - 10.26 (g) Warrant No. 3 dated March 30, 2002, issued to Quantum Industrial Partners LDC.
 - 10.27 (g) Warrant No. 4 dated March 30, 2002, issued to SFM Domestic Investments LLC.
 - 10.28 (h) Common Stock and Warrant Purchase Agreement, dated May 24, 2002, by and between investors listed on Schedule 1 thereto.
 - 10.29 (i) Series C Preferred Stock and Note Purchase Agreement, dated September 27, 2002, and the investors listed on Schedule 1 thereto.
- 40
- 10.30 (j) Employment Agreement, dated as of July 31, 2002, by and between the Company and
 - 10.31 (j) Amendment No.4 to Financing Agreement, dated December 19, 2002, between the Co Inc.
 - 10.32 (j) Employment Agreement, dated as of December 31, 2002, by and between the Company
 - 10.33 (j) Note and Warrant Purchase Agreement, dated January 28, 2003, by and between the listed on Schedule 1 thereto.
 - 10.34 (j) Warrant No. 1 dated January 28, 2003, issued to Quantum Industrial Partners LDC
 - 10.35 (j) Warrant No. 2 dated January 28, 2003, issued to SFM Domestic Investments LLC.
 - 10.36 (j) Series D Preferred Stock Purchase Agreement, dated March 12, 2003, by and betwe investors listed on Schedule 1 thereto.
 - 10.37 (j) Amendment No. 5 to Financing Agreement, dated March 17, 2003, between the C Inc.

Edgar Filing: BLUEFLY INC - Form 10-K

- 10.38 (j) Warrant No. 4 dated March 17, 2003, issued to Quantum Industrial Partners LDC.
 - 10.39 (j) Warrant No. 5 dated March 17, 2003, issued to SFM Domestic Investments LLC.
 - 10.40 (k) Series E Preferred Stock Purchase Agreement, dated May 21, 2003, by and investors listed on Schedule 1 thereto.
 - 10.41 (l) Note Purchase Agreement, dated as of July 16, 2003, by and between the Registrant and investors listed on Schedule 1 thereto.
 - 10.42 (l) Demand Promissory Note, dated as of July 16, 2003, issued to Quantum Industrial Partners LDC.
 - 10.43 (l) Demand Promissory Note, dated as of July 16, 2003, issued to SFM Domestic Investments LLC.
 - 10.44 (m) Note Purchase Agreement, dated as of October 17, 2003, by and between the Registrant and investors listed on Schedule 1 thereto.
 - 10.45 (m) Demand Promissory Note, dated as of October 17, 2003, issued to Quantum Industrial Partners LDC.
 - 10.46 (m) Demand Promissory Note, dated as of October 17, 2003, issued to SFM Domestic Investments LLC.
 - 10.47 (n) Employment Agreement dated as of September 22, 2003 by and between Bluefly, Inc. and the Registrant.
 - 10.48 (n) Amendment to Financing Agreement dated October 2, 2003.
 - 10.49 (o) Common Stock and Warrant Purchase Agreement dated January 9, 2004 by and among the Registrant and investors listed on Schedule 1 thereto.
 - 10.50 (p) Amendment to Promissory Notes, dated as of January 12, 2004, by and among the Registrant, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
 - 10.51 (q) Amended and Restated Financing Agreement, dated as of April 21, 2004, by and among the Registrant, Rosenthal & Rosenthal, Inc. and the Company.
 - *10.52 (r) Amendment, dated as of March 17, 2004, to the Services Agreement, dated as of August 26, 2004, between the Registrant, Distribution Associates, Inc. and the Company.
 - *10.53 (s) CallTech Master Agreement for Outsourcing Contact Center Support, dated as of August 26, 2004, between the Registrant and CallTech Communications, LLC.
- 41
- 10.54 (t) Separation Agreement and General Release of All Claims by and between the Registrant and the Company as of August 26, 2004.
 - 10.55 (u) Employment Agreement, dated as of October 14, 2004, by and between the Company and the Registrant.
 - 10.56 (v) Amendment No. 2, dated as of February 18, 2005, to Amended and Restated Financing Agreement, dated as of April 21, 2004, by and between the Company and Rosenthal & Rosenthal, Inc.
 - 10.57 (v) Amendment to Promissory Notes, dated as of February 18, 2005, by and among the Registrant, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
 - 10.58 Bluefly, Inc. 2005 Stock Incentive Plan
 - 21.1 Subsidiaries of the Registrant.
 - 23.1 Consent of PricewaterhouseCoopers LLP.

Edgar Filing: BLUEFLY INC - Form 10-K

- 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 101 of 2002.
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 101 of 2002.

* Confidential treatment requested as to certain portions of this Exhibit. Such portions have been redacted.

- (a) Incorporated by reference to the Company's Quarterly report filed on Form 10-QSB for the quarterly period ended March 31, 1997.
- (b) Incorporated by reference to the Company's Quarterly report filed on Form 10-QSB for the quarterly period ended June 30, 1999.
- (c) Incorporated by reference to the Company's Annual report filed on Form 10-KSB for the year ended December 31, 1999.
- (d) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2000.
- (e) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended September 30, 2000.
- (f) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2000.
- (g) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2001.
- (h) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2002.
- (i) Incorporated by reference to the Company's report on Form 8-K, dated October 1, 2002. (j) Incorporated by reference to the Company's Annual Report filed on Form 10-K for the year ended December 31, 2002.
- (k) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2003.
- (l) Incorporated by reference to the Company's report on Form 8-K, dated July 17, 2003.
- (m) Incorporated by reference to the Company's report on Form 8-K, dated October 20, 2003.
- (n) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended September 30, 2003.
- (o) Incorporated by reference to the Company's report on Form 8-K, dated January 13, 2004.
- (p) Incorporated by reference to the Company's report on Form 8-K, dated January 16, 2004.
- (q) Incorporated by reference to the Company's report on Form 8-K, dated

Edgar Filing: BLUEFLY INC - Form 10-K

April 22, 2004.

- (r) Incorporated by reference to the Company's quarterly report on Form 10-Q for the quarterly period ended March 31, 2004.
- (s) Incorporated by reference to the Company's quarterly report on Form 10-Q for the quarterly period ended June 30, 2004.
- (t) Incorporated by reference to the Company's report on Form 8-K, dated August 30, 2004.
- (u) Incorporated by reference to the Company's report on Form 8-K, dated October 29, 2004.
- (v) Incorporated by reference to the Company's report on form 8-K, dated February 22, 2005.

* Confidential treatment has been requested as to certain portions of this Exhibit. Such portions have been redacted.

42

SIGNATURES

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

BLUEFLY, INC.

By: /s/ Melissa Payner-Gregor

Melissa Payner-Gregor
Chief Executive Officer and President

March 1, 2005

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
-----	-----	-----
/s/ Alan Kane ----- Alan Kane	Chairman of the Board	March 1
/s/ Melissa Payner-Gregor ----- Melissa Payner-Gregor	Chief Executive Officer (Principal Executive Officer), President and Director	March 1
/s/ Patrick C. Barry ----- Patrick C. Barry	Chief Financial Officer and Chief Operating Officer (Principal Accounting Officer)	March 1
/s/ Barry Erdos -----	Director	March 1

Edgar Filing: BLUEFLY INC - Form 10-K

Barry Erdos

/s/ Martin Miller

Director

March 1

Martin Miller

/s/ Neal Moszkowski

Director

March 1

Neal Moszkowski

/s/Christopher McCann

Director

March 1

Christopher McCann

/s/ David Wassong

Director

March 1

David Wassong