OVERSTOCK.COM, INC
Form 10-Q
August 04, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended June 30, 2006
	Or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the transition period from to

Commission file number: 000-49799

OVERSTOCK.COM, INC.

(Exact name of registrant as specified in its charter)

Delaware	**87-0634302**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

6350 South 3000 East

Salt Lake City, Utah 84121

(Address, including zip code, of

Registrant s principal executive offices)

Registrant s telephone number, including area code: **(801) 947-3100**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o x No

There were 22,249,898 shares of the Registrant s common stock, par value $0.0001, outstanding on August 2, 2006.

TABLE OF CONTENTS

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	December 31, 2005	June 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 56,224	$ 45,665
Marketable securities	55,799	
Cash, cash equivalents and marketable securities	112,023	45,665
Accounts receivable, net	11,695	9,838
Inventories, net	93,269	74,822
Prepaid inventory	9,633	3,247
Prepaid expenses	8,508	9,776
Total current assets	235,128	143,348
Restricted cash	253	
Property and equipment, net	63,914	64,611
Goodwill	13,169	13,169
Other long-term assets, net	13,449	12,069
Total assets	$ 325,913	$ 233,197
Liabilities, Redeemable Securities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 101,436	$ 35,920
Accrued liabilities	46,847	23,504
Capital lease obligations, current	6,683	5,401
Total current liabilities	154,966	64,825
Capital lease obligations, non-current	3,058	3,964
Convertible senior notes	74,935	75,107
Total liabilities	232,959	143,896
Commitments and contingencies (Note 11)		
Redeemable common stock, $0.0001 par value, 446 and 385 shares issued and outstanding as of December 31, 2005 and June 30, 2006	3,205	2,398
Stockholders equity:		
Preferred stock, $0.0001 par value, 5,000 shares authorized, no shares issued and outstanding as of December 31, 2005 and June 30, 2006		
Common stock, $0.0001 par value, 100,000 shares authorized, 20,571 shares and 21,827 shares issued as of December 31, 2005 and June 30, 2006, respectively	2	2
Additional paid-in capital	250,939	280,891
Accumulated deficit	(96,829)	(128,544)
Treasury stock, 1,687 and 1,664 shares at cost as of December 31, 2005 and June 30, 2006, respectively	(65,325)	(65,251)
Accumulated other comprehensive income (loss)	962	(195)

Total stockholders equity	89,749	86,903
Total liabilities, redeemable securities and stockholders equity	$ 325,913	$ 233,197

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

3

Overstock.com, Inc.
Consolidated Statements of Operations (unaudited)
(in thousands, except per share data)

	Three months ended June 30, 2005	2006	Six months ended June 30, 2005	2006
Revenue				
Direct	$ 60,064	$ 68,770	$ 127,948	$ 148,480
Fulfillment partner	90,574	91,198	188,571	191,694
Total revenue	150,638	159,968	316,519	340,174
Cost of goods sold (1):				
Direct	51,567	61,473	109,829	132,176
Fulfillment partner	76,375	75,501	159,232	159,842
Total cost of goods sold	127,942	136,974	269,061	292,018
Gross profit	22,696	22,994	47,458	48,156
Operating expenses (1):				
Sales and marketing	14,499	12,171	31,325	25,348
Technology	6,103	15,048	10,201	28,637
General and administrative	7,566	12,453	14,913	25,807
Total operating expenses	28,168	39,672	56,439	79,792
Operating loss	(5,472)	(16,678)	(8,981)	(31,636)
Interest income	896	2,215	1,540	2,530
Interest expense	(1,517)	(1,275)	(2,962)	(2,542)
Other income, net	4,170	(1)	4,170	(1)
Net loss	(1,923)	(15,739)	(6,233)	(31,649)
Deemed dividend related to redeemable common stock	(47)	(33)	(93)	(66)
Net loss attributable to common shares	$ (1,970)	$ (15,772)	$ (6,326)	$ (31,715)
Net loss per common share basic and diluted	$ (0.10)	$ (0.78)	$ (0.32)	$ (1.60)
Weighted average common shares outstanding basic and diluted	19,709	20,159	19,785	19,774

(1) Includes stock-based compensation from employee options as follows:

Cost of goods sold direct	$5	$109	$7	$205
Sales and marketing	$4	$79	$5	$149
Technology	$9	$181	$12	$340
General and administrative	$35	$719	$49	$1,352

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

4

Overstock.com, Inc.
Consolidated Statements of Stockholders Equity
and Comprehensive Income (unaudited)

	Common stock Shares	Amount	Additional Paid-in Capital	Accumulated deficit	Treasury stock Shares	Amount	Accumulated Other Comprehensive Income (loss)	Total
	(amounts in thousands)							
Balance at December 31, 2005	20,571	$ 2	$ 250,939	$ (96,829)	(1,687)	$ (65,325)	$ 962	$ 89,749
Exercise of stock options and warrants	153		1,461					1,461
Issuance of common stock	1,042		25,000					25,000
Treasury stock issued to employees as compensation			538		23	74		612
Stock-based compensation to consultants in exchange for services			34					34
Stock-based compensation expense from employee options			2,046					2,046
Deemed dividend related to redeemable common stock				(66)				(66)
Lapse of rescission rights on redeemable common stock	61		873					873
Comprehensive income (loss):								
Net loss				(31,649)				(31,649)
Unrealized gain on marketable securities							740	740
Reclassification adjustment for (gains) included in net loss							(1,868)	(1,868)
Cumulative translation adjustment							(29)	(29)
Total comprehensive loss								(32,806)
Balance at June 30, 2006	21,827	$ 2	$ 280,891	$ (128,544)	(1,664)	$ (65,251)	$ (195)	$ 86,903

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

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

	Three months ended June 30,		Six months ended June 30,		Twelve months ended June 30,	
	2005	2006	2005	2006	2005	2006
Cash flows from operating activities:						
Net loss	$ (1,923)	$ (15,739)	$ (6,233)	$ (31,649)	$ (6,339)	$ (50,334)
Adjustments to reconcile net loss to cash provided by (used in) operating activities						
Depreciation and amortization	2,930	7,709	4,565	14,544	6,856	25,593
Realized (gain) loss from marketable securities	(25)	(1,868)	(26)	(2,085)	(28)	1,292
Realized loss on disposition of property and equipment		1		599	34	2,056
Stock-based compensation expense from employee options	53	1,088	73	2,046	175	2,045
Stock options issued to consultants for services	(15)	(9)	(415)	34	294	60
Treasury stock issued to employees as compensation	60	105	311	612	311	744
Amortization of debt discount and deferred financing fees	116	139	423	278	570	475
Gain from retirement of convertible senior notes	(4,170)		(4,170)		(4,170)	(1,988)
Changes in operating assets and liabilities, net of effect of acquisition:						
Accounts receivable, net	755	(1,572)	3	1,857	867	(3,255)
Inventories, net	(11,419)	6,529	(14,989)	18,447	(29,784)	(13,275)
Prepaid inventory	(503)	5,592	1,912	6,386	(5,756)	7,163
Prepaid expenses and other assets	1,666	716	(4,636)	(1,164)	(5,721)	(1,467)
Other long-term assets, net	603	(29)	(11)	18	415	(2,122)
Accounts payable	(374)	(1,181)	(24,574)	(65,516)	17,964	(4,487)
Accrued liabilities	2,148	(7,663)	2,494	(23,343)	15,500	(2,271)
Net cash used in operating activities	(10,098)	(6,182)	(45,273)	(78,936)	(8,812)	(39,771)
Cash flows from investing activities:						
Decrease in restricted cash	179	55	769	253	1,042	833
Investments in marketable securities	(36,047)		(161,991)		(242,626)	(23,552)
Sales of marketable securities	102,926	49,475	162,188	56,756	175,087	110,833
Expenditures for property and equipment	(11,246)	(5,366)	(24,276)	(12,211)	(31,411)	(32,675)
Proceeds from the sale of property and equipment		1		1	20	2
Acquisition of Ski West (net of cash acquired)						(24,620)
Expenditures for other long-term assets				(100)		(100)
Net cash provided by (used in) investing activities	55,812	44,165	(23,310)	44,699	(97,888)	30,721
Cash flows from financing activities:						
Payments on capital lease obligations	(2,901)	(326)	(3,052)	(2,754)	(3,356)	(6,788)
Drawdown on line of credit		42,530		73,258		85,126
Payments on line of credit		(62,530)		(73,258)	(1,000)	(85,126)
Proceeds from issuance of convertible senior notes					116,199	
Payments to retire convertible senior notes	(27,935)		(27,935)		(27,935)	(7,735)
Payments of deferred financing fees					(301)	
Proceeds from the issuance of common stock		25,000		25,000	75,207	25,000
Purchase of treasury stock	(24,133)		(24,133)		(24,133)	
Purchased call options for purchase of treasury stock			(47,507)		(47,507)	
Settlement of call options for cash						7,937
Exercise of stock options and warrants	3,002	434	3,908	1,461	5,237	4,868
Net provided by (used in) financing activities	(51,967)	5,108	(98,719)	23,707	92,411	23,282
Effect of exchange rate changes on cash	(8)	(44)	(26)	(29)	(9)	83
Net increase (decrease) in cash and cash equivalents	(6,261)	43,047	(167,328)	(10,559)	(14,298)	14,315
Cash and cash equivalents, beginning of period	37,611	2,618	198,678	56,224	45,648	31,350
Cash and cash equivalents, end of period	$ 31,350	$ 45,665	$ 31,350	$ 45,665	$ 31,350	$ 45,665
Supplemental disclosure of cash flow information:						
Interest paid	1,907	1,531	2,493	1,809	2,596	4,424
Supplemental disclosures of non-cash flow information:						

Deemed dividend on redeemable common shares	47	33	93	66	164	158
Lapse of rescission rights		319		873		1,019
Equipment and software acquired under capital leases	308		15,505	2,274	15,505	4,632
Settlement of purchased call options for treasury stock	41,121				41,121	
Fair value of assets acquired, net of cash acquired						25,956
Fair value of liabilities assumed						(1,336)
Cash paid to purchase businesses	$	$	$	$	$	$ 24,620

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

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

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by Overstock.com, Inc. (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the audited annual consolidated financial statements and related notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2005. The accompanying unaudited consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of results for the interim periods presented. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management s best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

2. ACCOUNTING POLICIES

Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The consolidated financial statements also include the accounts of a variable interest entity for which the Company is the primary beneficiary (see Note 13). All significant intercompany account balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Internal-Use Software and Website Development

Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our websites and processes supporting our business. As required by Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,* we capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During the second quarters of 2005 and 2006, the Company capitalized $2.7 million and $3.9 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of $134,000 and $741,000 for those respective periods. During the six months ended June 30, 2005 and 2006, the Company capitalized $14.0 million and $12.0 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of $370,000 and $1.3 million for those respective periods.

Advertising expense

The Company recognizes advertising expenses in accordance with SOP 93-7 *Reporting on Advertising Costs*. As such, the Company expenses the costs of producing advertisements at the time production occurs or the first time the advertising takes place, and expenses the cost of communicating advertising in the period during which the advertising space or airtime is used. Internet advertising expenses are recognized as incurred based on the terms of the individual agreements, which are generally: 1) during the period customers are acquired; or 2) based on the number of clicks generated during a given period over the term of the contract. Advertising expense included in sales and marketing expenses totaled $14.1 million and $11.5 million during the three months ended June 30, 2005 and 2006, respectively. For the six months ended June 30, 2005 and 2006, advertising expense totaled $30.6 million and $24.0 million, respectively.

Stock-based Compensation

As of January 1, 2006, we adopted SFAS 123(R) *Share-based Payment an Amendment of FASB Statements No 123 and 95*, which requires us to measure compensation expense for all outstanding unvested share-based awards at fair value and recognize compensation expense over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates (see Note 7).

Recent accounting pronouncements

Based on our review of accounting standards released during the quarter ended June 30, 2006, we did not identify any standard requiring adoption that would have a significant impact on our consolidated financial statements for the periods presented.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. The effect of these reclassifications had no impact on net income, total assets, total liabilities, or stockholders equity.

3. MARKETABLE SECURITIES

During the first quarter of 2005, the Company purchased $49.9 million of Foreign Corporate Securities (Foreign Notes) which were scheduled to mature in November 2006 for $50.0 million in cash . The Foreign Notes did not have a stated interest rate, but were structured to return the entire principal amount and a conditional coupon if held to maturity. The conditional coupon would provide a rate of return dependent on the performance of a basket of eight Asian currencies against the U.S. dollar. If the Company redeemed the Foreign Notes prior to maturity, the Company would not realize the full amount of its initial investment.

Under SFAS No. 133, the Foreign Notes are considered to be derivative financial instruments and were marked-to-market quarterly. Any unrealized gain or loss related to the changes in value of the conditional coupon was recorded in the income statement as a component of interest income or expense. Any unrealized gain or loss related to the changes in the value of the Foreign Notes is recorded as a component of accumulated other comprehensive income (loss).

The Company purchased the Foreign Notes to manage its foreign currency risks related to the strengthening of Asian currencies compared to the U.S. dollar, which would reduce the inventory purchasing power of the Company in Asia. However, the Company determined that the Foreign Notes did not qualify as hedging derivative instruments. Nevertheless, management believes that such instruments are useful in managing the Company s associated risk.

On April 26, 2006, the Company sold the Foreign Notes for $49.5 million resulting in a gain on the bond instrument of $1.9 million, comprised of the realization of $1.9 million of unrealized gains which the Company recognized in the second quarter of 2006 as a component of interest income.

The Company had pledged its Foreign Notes as collateral for a $30.0 million revolving line of credit (see Note 9). Subsequent to the sale of the Foreign Notes, the borrowings under the Amended Credit Agreement (see Note 9) are now collateralized by cash balances held at Wells Fargo Bank, National Association.

4. OTHER COMPREHENSIVE LOSS

The Company follows SFAS No. 130, *Reporting Comprehensive Income.* This Statement establishes requirements for reporting comprehensive income and its components. The Company s comprehensive loss is as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2005	**2006**	**2005**	**2006**
Net loss	$ (1,923)	$ (15,739)	$ (6,233)	$ (31,649)

Net unrealized gain (loss) on marketable securities	321		(6)	
Unrealized gain on Foreign Notes		255		740
Reclassification adjustment for gains included in net loss		(1,868)		(1,868)
Foreign currency translation adjustment	(8)	(44)	(26)	(29)
Comprehensive loss	$ (1,610)	$ (17,396)	$ (6,265)	$ (32,806)

8

5. EARNINGS (LOSS) PER SHARE

In accordance with SFAS 128 Earnings per share , basic earnings (loss) per share is computed by dividing net income (loss) attributable to common shares by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) attributable to common shares for the period by the weighted average number of common and potential common shares outstanding during the period. Potential common shares, composed of incremental common shares issuable upon the exercise of stock options, warrants and convertible senior notes, are included in the calculation of diluted net loss per share to the extent such shares are dilutive.The following table sets forth the computation of basic and diluted earnings (loss) per share for the periods indicated (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2006	2005	2006
Net loss attributable to common shares	$ (1,970)	$ (15,772)	$ (6,326)	$ (31,715)
Weighted average common shares outstanding basic	19,709	20,159	19,785	19,774
Effective of dilutive securities:				
Employee stock options and warrants				
Convertible senior notes				
Weighted average common shares outstanding diluted	19,709	20,159	19,785	19,774
Earnings (loss) per common share basic:	$ (0.10)	$ (0.78)	$ (0.32)	$ (1.60)
Earnings (loss) per common share diluted:	$ (0.10)	$ (0.78)	$ (0.32)	$ (1.60)

The stock options, warrants and convertible senior notes outstanding were not included in the computation of diluted earnings per share because to do so would have been antidilutive. The number of shares of stock options and warrants outstanding at June 30, 2005 and 2006 was 1,493,000 shares and 1,225,000 shares, respectively. There were 446,000 warrants outstanding at June 30, 2005. No warrants were outstanding at June 30, 2006. As of June 30, 2006, the Company had $77.0 million of convertible senior notes outstanding, which could potentially convert into 1,010,000 shares of common stock in the aggregate.

6. BUSINESS SEGMENTS

Segment information has been prepared in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Segments were determined based on products and services provided by each segment. There were no inter-segment sales or transfers during the three or six months ended June 30, 2005 or 2006. The Company evaluates the performance of its segments and allocates resources to them based primarily on gross profit. The table below summarizes information about reportable segments for the three and six months ended June 30, 2005 and 2006 (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	Direct	Fulfillment partner	Consolidated	Direct	Fulfillment partner	Consolidated
2005						
Revenue	$ 60,064	$ 90,574	$ 150,638	$ 127,948	$ 188,571	$ 316,519
Cost of goods sold	51,567	76,375	127,942	109,829	159,232	269,061
Gross profit	$ 8,497	$ 14,199	22,696	$ 18,119	$ 29,339	47,458
Operating expenses		(28,168)				(56,439)
Other income (expense), net		3,549				2,748
Net loss		$ (1,923)				$ (6,233)
2006						
Revenue	$ 68,770	$ 91,198	$ 159,968	$ 148,480	$ 191,694	$ 340,174
Cost of goods sold	61,473	75,501	136,974	132,176	159,842	292,018
Gross profit	$ 7,297	$ 15,697	22,994	$ 16,304	$ 31,852	48,156
Operating expenses			(39,672)			(79,792)
Other income (expense), net			939			(13)
Net loss			$ (15,739)			$ (31,649)

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

The fulfillment partner segment includes revenues, direct costs and cost allocations associated with the Company s third party fulfillment partner sales and are earned from selling the merchandise of third parties over the Company s Websites. The costs for this segment include product costs, warehousing and fulfillment costs, credit card fees and customer service costs.

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

For the three and six months ended June 30, 2005 and 2006, over 99% of sales were made to customers in the United States of America. No individual geographical area within the U.S accounted for more than 10% of net sales in any of the periods presented. At December 31, 2005 and June 30, 2006, all of the Company s fixed assets were located in the United States of America.

7. STOCK-BASED COMPENSATION

Periods prior to the adoption of SFAS 123(R)

Prior to January 1, 2006, the Company accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees* , and related interpretations. The intrinsic value method of accounting resulted in compensation expense for stock options to the extent option exercise prices were set below market prices on the date of grant. Also, to the extent stock awards were forfeited prior to vesting, any previously recognized expense was reversed as an offset to operating expenses in the period of forfeiture.

The following table illustrates the effects on net loss and net loss per share as if the Company had applied the fair value recognition provisions of SFAS 123, *Accounting for Stock Based Compensation* , as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* to options granted under the Company s stock-based compensation plans prior to the adoption. For purposes of this pro forma disclosure, the value of the options was estimated using the Black-Scholes-Merton (BSM) option-pricing formula and amortized on a straight-line basis over the respective vesting periods of the awards. Disclosures for the three and six months ended June 30, 2006 are not presented because stock-based payments were accounted for under SFAS 123(R) s fair value method during this period.

	Three months ended June 30, 2005	Six months ended June 30, 2005
Net loss, as reported	$ (1,923)	$ (6,233)
Add: Stock-based employee compensation, as reported	53	73
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,011)	(1,915)
Pro forma net loss SFAS 123 fair value adjusted	$ (2,881)	$ (8,075)
Net loss per common share		
Basic and diluted - as reported	$ (0.10)	$ (0.32)
Basic and diluted - pro forma	$ (0.15)	$ (0.41)

Adoption of SFAS 123(R)

As of January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of stock options is determined using the BSM valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123. Such value is recognized as expense over the service period, net of estimated forfeitures, using the straight-line method under SFAS 123(R).

The adoption of SFAS 123(R) did not result in a cumulative benefit from accounting change, which reflects the net cumulative impact of estimating future forfeitures in the determination of period expense, rather than recording forfeitures when they occur as previously permitted, as we did not have unvested employee stock awards for which compensation expense was recognized prior to adoption of SFAS No. 123(R).

Prior to the adoption of SFAS 123(R), cash retained as a result of tax deductions relating to stock-based compensation was presented in operating cash flows, along with other tax cash flows, in accordance with the provisions of the Emerging Issues Task Force (EITF) Issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option.* SFAS 123(R) supersedes EITF 00-15, amends SFAS 95, *Statement of Cash Flows,* and requires tax benefits relating to excess stock-based compensation deductions to be prospectively presented in the statement of cash flows as financing cash inflows. As of the adoption of SFAS 123(R), we had fully reserved against any tax benefits resulting from stock-based compensation deductions in excess of amounts reported for financial reporting purposes.

On March 29, 2005, the SEC published Staff Accounting Bulletin (SAB) No. 107, which provides the Staff s views on a variety of matters relating to stock-based payments. SAB 107 requires stock-based compensation be classified in the same expense line items as cash compensation. The Company has reclassified stock-based compensation from prior periods to correspond to current period presentation within the same operating expense line items as cash compensation paid to employees.

The application of SFAS 123(R) had the following effect on the three and six months ended June 30, 2006 reported amounts relative to amounts that would have been reported using the intrinsic value method under previous accounting (in thousands, except per share amounts):

SFAS 123(R) Adjustments	**Three months ended June 30, 2006**	**Six months ended June 30, 2006**
Operating loss	$ (1,088)	$ (2,046)
Net loss	$ (1,088)	$ (2,046)
Net loss per common share basic and diluted	$ (0.05)	$ (0.10)

Valuation Assumptions for Stock Options

During the second quarter of 2006, 151,000 options were granted to employees with an estimated total grant-date fair value of $2.1 million. Of this amount, the Company estimated that the stock-based compensation for the awards not expected to vest was $549,000. During the three and six months ended June 30, 2006, the Company recorded stock-based compensation related to stock options of $1.1 million and $2.0 million , respectively.

The fair value for each stock option granted during the three months ended June 30, 2005 and 2006 was estimated at the date of grant using the BSM option-pricing model, assuming no dividends and the following assumptions.

	Three months ended June 30, 2005		2006	
Average risk-free interest rate	3.09	%	5.19	%
Average expected life (in years)	3.3		3.5	
Volatility	79.6	%	82.8	%

Expected Volatility: The fair value of stock based payments were valued using a volatility factor based on the Company s historical stock prices.

Expected Term: The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms and vesting provisions of the stock-based awards.

Expected Dividend: The Company has not paid any dividends and does not anticipate paying dividends in the foreseeable future.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used on the implied yield currently available on U.S. Treasury zero-coupon issues with remaining term equivalent to the expected term of the options.

Estimated Pre-vesting Forfeitures: When estimating forfeitures, the Company considers voluntary and involuntary termination behavior.

Stock Option Activity

The Company s board of directors adopted the Amended and Restated 1999 Stock Option Plan, the 2002 Stock Option Plan and the 2005 Equity Incentive Plan (collectively, the Plans), in May 1999, April 2002, and April 2005 respectively. Under these Plans, the Board of Directors may issue incentive stock options to employees and directors of the Company and non-qualified stock options to consultants of the Company. Options granted under these Plans generally expire at the end of five years and vest in accordance with a vesting schedule determined by the Company s Board of Directors, usually over four years from the grant date. As of the initial public offering, the Amended and Restated 1999 Stock Option Plan was terminated, and as of April 2005 the 2002 Stock Option Plan was terminated (except with regard to outstanding options). Future shares will be granted under the 2005 Equity Incentive Plan. As of June 30, 2006, 1,225,000 shares are available for future grants under the 2005 Equity Incentive Plan. The Company settles stock option exercises with newly issued common shares.

The following is a summary of stock option activity (in thousands, except per share data):

	Shares		Weighted Average Exercise Price
Outstanding January 1, 2006	1,299		$18.09
Granted	164		23.14
Exercised	(152	)	9.79
Forfeited	(86	)	23.35
Outstanding June 30, 2006	1,225		19.43

Options exercisable	June 30, 2006	726	14.47

The following table summarizes information about stock options as of June 30, 2006 (in thousands, except per share data):

	Options Outstanding				Options Exercisable			
Range of Exercise Prices	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
$2.00-$4.99	70	$ 4.46	1.10	$ 1,359	65	$ 4.42	1.08	$ 1,259
$5.00-$6.99	215	5.07	0.54	4,015	215	5.07	0.54	4,015
$7.00-$11.99	74	10.77	1.15	959	66	11.02	1.08	843
$12.00-$17.99	229	13.26	2.05	2,407	154	13.31	2.01	1,613
$18.00-$58.30	637	29.14	3.53	1,369	226	28.10	2.85	695
	1,225	19.43	2.44	10,109	726	14.47	1.67	8,425

Total compensation costs related to nonvested awards was approximately $8.1 million as of June 30, 2006. These nonvested awards are expected to be exercised over the weighted average period of 2.4 years.

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s average stock price of $23.76 during the quarter ended June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of June 30, 2006 was 634,000.

The weighted average exercise price of options granted during the three months ended June 30, 2006 was $23.02 per share. The total fair value of the shares vested during the three months ended June 30, 2006 was $896,000. The total intrinsic value of options exercised during the three month period ended June 30, 2006 was $667,000. The total cash received from employees as a result of employee stock option exercises during the three months ended June 30, 2006 was approximately $434,000. In connection with these exercises, there was no tax benefit realized by the Company due to the Company s current loss position.

8. PERFORMANCE SHARE PLAN

In January 2006, the Board and Compensation Committee adopted the Overstock.com Performance Share Plan, and approved grants to executive officers and certain employees of the Company. The Performance Share Plan provides for a three-year period for the measurement of the Company s attainment of the performance goal described in the form of grant, but at the Company s sole option the Company may make a payment of estimated amounts payable to a plan participant after two years.

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of the Company s common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan will be payable in cash. During interim and annual periods prior to the completion of the three-year measurement period, the Company records compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates include assumed future growth rates in revenues, gross margins and other factors. If the Company were to use different assumptions, the estimated compensation charges could be significantly different.

For the three and six months ended June 30, 2006, the Company recorded $500,000 and $900,000, respectively of compensation expense under the plan. As of June 30, 2006, the Company has accrued $900,000 in total compensation expense under the plan.

9. BORROWINGS

$30.0 million Amended Credit Agreement

On October 18, 2005, the Company entered into a sixth amendment to a credit agreement (Amended Credit Agreement) with Wells Fargo Bank, National Association. The Amended Credit Agreement provides a revolving line of credit to the Company of up to $30.0 million which the Company uses primarily to obtain letters of credit to support inventory purchases. The Amended Credit Agreement expires on December 31, 2007, however, the Company has an option to renew the Amended Credit Agreement annually. Interest on borrowings is payable monthly and accrued at either (i) 1.35%

13

above LIBOR in effect on the first day of an applicable fixed rate term, or (ii) at a fluctuating rate per annum determined by the bank to be one half a percent (0.50%) above daily LIBOR in effect on each business day a change in daily LIBOR is announced by the bank. Unpaid principal, together with accrued and unpaid interest is due on the maturity date. The Amended Credit Agreement requires the Company to comply with certain covenants, including restrictions on mergers, business combinations or transfer of assets. The Company was in compliance with these covenants at June 30, 2006.

At June 30, 2006, borrowings and outstanding letters of credit under the Amended Credit Agreement are collateralized by cash balances held at Wells Fargo Bank, National Association.

At June 30, 2006, no amounts were outstanding under the Amended Credit Agreement, and Letters of Credit totaling $11.8 million were issued on behalf of the Company.

$40.0 million WFRF Agreement

On December 12, 2005, the Company entered into a Loan and Security Agreement (the WFRF Agreement) with Wells Fargo Retail Finance, LLC and related security agreements and other agreements described in the WFRF Agreement.

The WFRF Agreement provides for advances to the Company and for the issuance of letters of credit for its account of up to an aggregate maximum of $40.0 million. The Company has the right to increase the aggregate maximum amount available under the facility to up to $50.0 million during the first two years of the facility. The amount actually available to the Company may be less and may vary from time to time, depending on, among other factors, the amount of its eligible inventory and receivables. The Company s obligations under the WFRF Agreement and all related agreements are collateralized by all or substantially all of the Company s and its subsidiaries assets. The Company s obligations under the WFRF Agreement are cross-collateralized with its assets pledged under its $30.0 million credit facility with Wells Fargo Bank, National Association. The term of the WFRF Agreement is three years, expiring on December 12, 2008. The WFRF Agreement contains standard default provisions.

Advances under the WFRF Agreement bear interest at either (a) the rate announced, from time to time, within Wells Fargo Bank, National Association at its principal office in San Francisco as its prime rate or (b) a rate based on LIBOR plus a varying percentage between 1.25% and 1.75%; however, the annual interest rate on advances under the WFRF Agreement will be at least 3.50%. The WFRF Agreement includes affirmative covenants as well as negative covenants that prohibit a variety of actions without the lender s approval, including covenants that limit the Company s ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another person, (d) sell assets, (e) change its name or the name of any of its subsidiaries, (f) make certain changes to its business, (g) optionally prepay, acquire or refinance indebtedness, (h) consign inventory, (i) pay dividends on, or purchase, acquire or redeem shares of, its capital stock, (j) change its method of accounting, (k) make investments, (l) enter into transactions with affiliates, or (m) store any of its inventory or equipment with third parties. The Company was in compliance with these covenants as of June 30, 2006.

At June 30, 2006, no amounts were outstanding under the WFRF Agreement.

Capital leases

The Company leases certain software and computer equipment under three non-cancelable capital leases that expire at various dates through 2008. Software and equipment relating to the capital leases totaled $15.4 million and $17.7 million at December 31, 2005 and June 30, 2006, respectively, with accumulated amortization of $10.1 and $11.0 million at those respective dates. Depreciation of assets recorded under capital leases was $553,000 and $1.5 million for the three months ended June 30, 2005 and 2006, respectively and $1.4 million and $3.3 million for the six months ended June 30, 2005 and 2006, respectively.

Future minimum lease payments under capital leases are as follows (in thousands):

Twelve months ending June 30,	
2007	$ 5,734
2008	3,965
2009	
Total minimum lease payments	9,699
Less: amount representing interest	(334)

Present value of capital lease obligations	9,365
Less: current portion	(5,401)
Capital lease obligations, non-current	$ 3,964

10. 3.75% CONVERTIBLE SENIOR NOTES

In November 2004, the Company completed an offering of $120.0 million of 3.75% Convertible Senior Notes (the Senior Notes). Proceeds to the Company were $116.2 million, net of $3.8 million of initial purchaser s discount and debt issuance costs. The discount and debt issuance costs are being amortized using the straight-line method which approximates the interest method. During the three months ended June 30, 2005 and 2006, the Company recorded amortization of discount and debt issuance costs related to this offering totaling $116,000 and $139,000. Amortization of discount and debt issuance costs for the six months ended June 30, 2005 and 2006 totaled $423,000 and $278,000, respectively. Interest on the Senior Notes is payable semi-annually on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2011 and are unsecured and rank equally in right of payment with all existing and future unsecured, unsubordinated debt and senior in right of payment to any existing and future subordinated indebtedness.

The Senior Notes are convertible at any time prior to maturity into the Company s common stock at the option of the note holders at a conversion price of $76.23 per share or, approximately 1.010 million shares in aggregate (subject to adjustment in certain events, including stock splits, dividends and other distributions and certain repurchases of the Company s stock, as well as certain fundamental changes in the ownership of the Company). Beginning December 1, 2009, the Company has the right to redeem the Senior Notes, in whole or in part, for cash at 100% of the principal amount plus accrued and unpaid interest. Upon the occurrence of a fundamental change (including the acquisition of a majority interest in the Company, certain changes in the Company s board of directors or the termination of trading of the Company s stock) meeting certain conditions, holders of the Senior Notes may require the Company to repurchase for cash all or part of their notes at 100% of the principal amount plus accrued and unpaid interest.

The indenture governing the Senior Notes requires the Company to comply with certain affirmative covenants, including making principal and interest payments when due, maintaining our corporate existence and properties, and paying taxes and other claims in a timely manner. The Company was in compliance with these covenants at June 30, 2006.

In June and November 2005, the Company retired $33.0 million and $10.0 million of the Senior Notes for $27.9 million and $7.8 million in cash for each respective retirement. As a result of the note retirements in June and November, the Company recognized gains of $4.2 million and $2.0 million, net of the associated unamortized discount of $1.2 million during the quarters ended June 30, 2005 and December 31,2005, respectively. As of June 30, 2006, $77.0 million of the Senior Notes remained outstanding.

11. COMMITMENTS AND CONTINGENCIES

Commitments

The Company began leasing approximately 154,000 rentable square feet for a term of ten years beginning July 2005. In February 2005, the Company and Old Mill Corporate Center III, LLC (the Lessor) entered into a Tenant Improvement Agreement (the OMIII Agreement) relating to the office building. The OMIII Agreement requires the Company to provide either a cash deposit or a letter of credit in the amount of $500,000 to the Lessor to provide funds for the removal of the improvements upon the termination of the lease. The Company s bank issued a letter of credit for $500,000 to the Lessor on behalf of the Company.

The Company leases 480,000 square feet for its warehouse facilities in Utah under operating leases which expire in August 2012.

In June 2005, the Company entered into a non-cancelable operating lease for certain computer equipment expiring in April 2008. It is expected that such leases will be renewed by exercising purchase options or replaced by leases of other computer equipment. In June 2006, the Company entered into a non-cancelable operating lease for certain computer equipment expiring in June 2008. It is expected that such leases will be renewed by exercising purchase options or replaced by leases of other computer equipment.

Minimum future payments under these leases are as follows (in thousands):

Twelve months ended June 30,	
2007	$ 12,301
2008	9,687
2009	8,186
2010	8,416
2011	7,959
Thereafter	31,611

	$	78,160

15

Rental expense for operating leases totaled $498,000 and $1.7 million for the quarters ended June 30, 2005 and 2006, respectively. For the six months ended June 30, 2005 and 2006, rental expense totaled $998,000 and $3.0 million, respectively.

Legal Proceedings

From time to time, we receive claims of and become subject to consumer protection, employment, intellectual property and other commercial litigation related to the conduct of our business. Such litigation could be costly and time consuming and could divert our management and key personnel from our business operations. The uncertainty of litigation increases these risks. In connection with such litigation, we may be subject to significant damages or equitable remedies relating to the operation of our business and the sale of products on our websites. Any such litigation may materially harm our business, prospects, results of operations, financial condition or cash flows. However, we do not currently believe that any of our outstanding litigation will have a material adverse effect on our financial statements.

In October 2003, Tiffany (NJ) Inc. and Tiffany and Company filed a complaint against us in the United States District Court for the Southern District of New York alleging that we have distributed counterfeit and otherwise unauthorized Tiffany product in violation of federal copyright and trademark law and related state laws. In January and February 2005, Tiffany (NJ) Inc. and Tiffany and Company filed five additional complaints against us in the United States District Court for the Southern District of New York alleging that we have distributed counterfeit and otherwise unauthorized Tiffany product in violation of federal copyright and trademark law and related state laws. We reached a confidential agreement that settled all of these cases and all of the cases were dismissed on July 14, 2006.

In September 2004, we received a letter from BTG International Inc. claiming that certain of our business practices and online marketing information technology systems infringe patents owned by BTG. On September 14, 2004, without engaging in any meaningful discussion or negotiation with us, BTG filed a complaint in the United States District Court of Delaware alleging that certain of our business practices and online marketing information technology systems infringe a single patent owned by BTG. We reached a confidential agreement that settled the case and it was dismissed on July 12, 2006.

In December 2003, we received a letter from Furnace Brook claiming that certain of our business practices and our on-line ordering system infringe a single patent owned by Furnace Brook. After diligent efforts to show that we do not infringe the patent and Furnace Brook s continual demands that we enter into licensing arrangements with respect to the asserted patent, on August 12, 2005, we filed a complaint in the United States District Court of Utah, Central Division, seeking declaratory judgment that we do not infringe any valid claim of the Furnace Brook patent. Furnace Brook filed a motion to dismiss our complaint for lack of personal jurisdiction over Furnace Brook in Utah. On October 31, 2005, the United States District Court of Utah, Central Division, issued a decision to dismiss our complaint for lack of personal jurisdiction over Furnace Brook. On December 14, 2005, we filed an appeal of the Utah decision with the United States Court of Appeals for the Federal Circuit. The United States Court of Appeals for the Federal Circuit has scheduled a oral argument on that appeal for August 7, 2006. On August 18, 2005, shortly after we filed the complaint in Utah, Furnace Brook filed a complaint in the United States District Court for the Southern District of New York, alleging that certain of our business practices and our on-line ordering system infringe a single patent owned by Furnace Brook. On September 9, 2005, we filed an answer denying the material allegations in Furnance Brook s claims. Although we have filed an answer and believe we have defenses to the allegations and intend to pursue them vigorously, we do not have sufficient information to assess the probability of success or the amount of potential damages.

On August 11, 2005, along with a shareholder plaintiff, we filed a complaint against Gradient Analytics, Inc.; Rocker Partners, LP; Rocker Management, LLC; Rocker Offshore Management Company, Inc. and their respective principals. We, along with a second shareholder plaintiff, filed the complaint in the Superior Court of California, County of Marin. On October 12, 2005, we filed an amended complaint against the same entities alleging libel, intentional interference with prospective economic advantage and violations of California s unfair business practices act. On March 7, 2006, the court denied the defendants demurrers to and motions to strike the amended complaint. The defendants have each filed a motion to appeal the court s decision and we have responded; the court has ruled that this appeal stays discovery in the case. We intend to pursue this action vigorously.

On May 9, 2006 the Company received a notice of an investigation and subpoena from the Securities and Exchange Commission, Salt Lake City District Office. The subpoena requests a broad range of documents, including, among other documents, all documents relating to the Company s accounting policies, the Company s targets, projections or estimates related to financial performance, the Company s recent restatement of its financial statements, the filing of its complaint against Gradient Analytics, Inc., the development and implementation of certain new technology systems and disclosures of progress and problems with those systems, communications with and regarding investment analysts, communications

regarding shareholders who did not receive the Company s proxy statement in April 2006, communications with certain shareholders, and communications regarding short selling, naked short selling, purchases and sales of Company stock, obtaining paper certificates, and stock loan or borrow of Company shares. The Company has responded to much of the subpoena and anticipates having its complete response by mid-August.

12. INDEMNIFICATIONS AND GUARANTEES

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

13. VARIABLE INTEREST ENTITY

In August 2004, the Company entered into an agreement which allows the Company to lend up to $10.0 million to an entity for the purpose of buying diamonds and other jewelry, primarily to supply a new category within our jewelry store which allows customers purchasing diamond rings to select both a specific diamond and ring setting. In November 2004, the Company loaned the entity $8.4 million. The promissory note bears interest at 3.75% per annum. In addition, the Company receives fifty percent (50%) of any profits of the entity. Interest on the loan is due and payable quarterly on the fifteenth day of February, May, August and November, commencing on November 15, 2004 until the due date of November 30, 2006, on which all principal and interest accrued and unpaid thereon, shall be due and payable. The promissory note is collateralized by all of the assets of the entity.

The Company has a ten year option to purchase (Purchase Option) 50% of the ownership and voting interest of the entity. The exercise price of the Purchase Option is the sum of (a) one thousand dollars, and (b) $3.0 million, which may be paid, at the Company s election, in cash or by the forgiveness of $3.0 million of the entity s indebtedness to the Company.

The entity was evaluated in accordance with FASB Interpretation No. 46 Revised, *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51,* and it was determined to be a variable interest entity for which the Company was determined to be the primary beneficiary. As such, the financial statements of the entity are consolidated into the financial statements of the Company.

The carrying amount and classification of the consolidated assets that are collateral for the entity s obligations include (in thousands):

	June 30, 2006
Cash	$ 75
Accounts receivable	48
Inventory	6,572
Prepaid expenses	21
Property and equipment	196
	$ 6,912

During the first quarter of 2006, the Company temporarily removed the functionality for its customers to design jewelry from its Website, and therefore the entity plans to sell its inventory through other sales channels. During the second quarter of 2006, the Company received $1.0 million from the entity to paydown a portion of the promissory note.

14. STOCK OFFERINGS

On May 1, 2006, the Company sold approximately 1.042 million shares of common stock for an aggregate price of $25.0 million.

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

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements. These statements relate to our, and in some cases our customers or other third parties , future plans, objectives, expectations, intentions and financial performance and the assumptions that underlie these statements. These forward-looking statements include, but are not limited to, statements regarding the following: our beliefs and expectations regarding the seasonality of our direct and fulfillment partner revenue; our beliefs regarding the sufficiency of our capital resources; planned distribution and order fulfillment capabilities; our beliefs, intentions and expectations regarding improvements of our order processing systems and capabilities; our intentions regarding the development of enhanced technologies and features; our intentions regarding the expansion of our customer service capabilities; our belief and intentions regarding improvements to our general and administrative functions; our beliefs and intentions regarding enhancements to our sales and marketing activities; our beliefs regarding the potential for growth in our customer base; our beliefs and intentions regarding our expansion into new markets, including international markets; our beliefs and intentions about entering into agreements to provide products and services to retail chains and other businesses; our belief regarding potential development of new Websites; our beliefs, intentions and expectations regarding promotion of new or complimentary product and sales formats; our belief, intentions and expectations regarding the expansion of our product and service offerings; our beliefs and intentions regarding expanding our market presence through relationships with third parties; our beliefs regarding the pursuit of complimentary businesses and technologies; our beliefs regarding the adequacy of our insurance coverage; our beliefs, intentions and expectations regarding litigation matters and legal proceedings, our defenses to such matters and our contesting of such matters; our beliefs and expectations regarding our existing cash and cash equivalents, cash requirements and sufficiency of capital; and our beliefs and expectations regarding interest rate risk, our investment activities and the effect of changes in interest rates.

These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties please see Item 1A Risk Factors and the description of risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2005. These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.

Overview

We are an online closeout retailer offering discount brand name merchandise, including bed-and-bath goods, home décor, kitchenware, watches, jewelry, electronics and computers, sporting goods, apparel, designer accessories and limited travel services, among other products. We also sell books, magazines, CDs, DVDs, videocassettes and video games (BMVG), and we operate as part of our Website an online auction site a marketplace for the buying and selling of goods between our customers. Our Website includes five main tabs: Shopping; Books, Music, Movies and Games; Wholesale; Auctions; and Travel.

Our company, based in Salt Lake City, Utah, was founded in 1997, and we launched our first Website through which customers could purchase products in March 1999. Our Websites offer our customers an opportunity to shop for bargains conveniently, while offering our suppliers an alternative inventory liquidation distribution channel. We continually add new, limited inventory products to our Websites in order to create an atmosphere that encourages customers to visit frequently and purchase products before our inventory sells out. In eight departments under the Shopping tab on our main Website, www.overstock.com, we offer approximately 156,000 products. Additionally, we offer approximately 971,000 media products on our BMVG tab.

Closeout merchandise is typically available in inconsistent quantities and prices and often is only available to consumers after it has been purchased and resold by disparate liquidation wholesalers. We believe that the traditional liquidation market is therefore characterized by fragmented supply and fragmented demand. We utilize the Internet to aggregate both supply and demand and create a more efficient market for liquidation merchandise. Our objective is to provide a one-stop destination for discount shopping for products and services proven to be successfully sold through the Internet.

Our Business

Overstock utilizes the Internet to create a more efficient market for liquidation merchandise. We provide consumers and businesses with quick and convenient access to high-quality, brand-name merchandise at discount prices. Our shopping business includes both a direct business and a fulfillment partner business. During the three and six months ended June 30, 2006, no single customer accounted for more than 1% of our total revenue. Products from our direct segment and fulfillment partner segment are available to both consumers and businesses through our Wholesale bulk purchase program.

Direct business

Our direct business includes sales made to individual consumers and businesses, which are fulfilled from our warehouses in Salt Lake City, Utah or our outsourced warehouses located in Plainfield, Indiana. During the three months ended June 30, 2006, we fulfilled approximately 36% of all orders through our warehouses. Our warehouses generally ship between 12,000 and 14,000 orders per day, and up to approximately 34,000 orders per day during peak periods, using overlapping daily shifts.

Fulfillment partner business

For our fulfillment partner business, we sell merchandise of other retailers, cataloguers or manufacturers (fulfillment partners) through our Website. We are considered to be the primary obligor for the majority of these sales transactions, and we assume the risk of loss on the returned items. As a consequence, we record revenue from the majority of these sales transactions involving our fulfillment partners (excluding travel products) on a gross basis. Our use of the term partner or fulfillment partner does not mean that we have formed any legal partnerships with any of our fulfillment partners. We currently have fulfillment partner relationships with 478 third parties which post approximately 62,000 non-BMVG products, as well as most of the BMVG products and a portion of our current travel offerings, on our Websites.

Our revenue from sales on our shopping site from both the direct and fulfillment partner businesses is recorded net of returns, coupons and other discounts. Our returns policy for all products other than those sold in our Electronics and Computers department provides for a $4.95 restocking fee and the provision that we will not accept product returns initiated more than twenty days after the shipment date. We charge a 15% restocking fee (instead of the $4.95 restocking fee) on all items returned for non-defective reasons from the Electronics and Computers department.

Unless otherwise indicated or required by the context, the discussion herein of our financial statements, accounting policies and related matters, pertains to our shopping sites (Shopping and BMVG) and not necessarily to our auction or travel tabs on our Websites.

Wholesale business

In August 2004, we merged our B2B site (www.overstockb2b.com) into our B2C site, and opened a Club O Gold membership program (into which our current B2B customers were grandfathered). The terms of this program include an annual fee ($99.95), Club O Gold pricing (that is, our B2C price less 5% on single product purchases and steeper discounts for products purchased in bulk), and access to a special, small business-focused, customer service team. During 2005, we integrated this program into our Wholesale tab. For this tab, we eliminated the membership fee, and have added a number of suppliers specific to various industry verticals, such as florist supplies, restaurant supplies, and office supplies.

Travel business

We operate a discount travel department as part of our Website. We use fulfillment partners to supply the travel products and services (flights, hotels, rental cars, etc.). We currently offer air, hotel and car reservation services as well as cruise and vacation packages.

On July 1, 2005, we acquired all the outstanding capital stock of Ski West, Inc. (Ski West), an on-line travel company whose proprietary technology provides easy consumer access to a large, fragmented, hard-to-find inventory of lodging, vacation, cruise and transportation bargains. The travel products are primarily in popular ski areas in the U.S. and Canada, with more recent expansion into the Caribbean and Mexico, as well as cruises. We paid an aggregate of $25.1 million (including $111,000 of capitalized acquisition related expenses) for Ski West, and we may be subject to additional earn-out payments (based on a percentage of operating profits for each of the four calendar years beginning with 2006 as follows: 50%, 33.3%, 20%, and 10%, respectively), subject to reduction under certain circumstances, pursuant to a Stock Purchase Agreement dated June 24, 2005 and as amended to date, among the Company, Ski West, and all of the former shareholders of Ski West.

Effective upon the closing, Ski West became our wholly-owned subsidiary, and we integrated the Ski West travel offerings with our existing travel offerings and changed its name to OTravel.com, Inc. OTravel.com generates merchant hotel revenues, which are billed to customers and recognized on a net basis at the time of booking since all transactions are nonrefundable and generally noncancelable and OTravel.com has no significant post-delivery obligations. A reserve for chargebacks and cancellations is recorded at the time of the transaction based on historical experience.

All other revenues are considered agency revenues, and are derived from airline ticket transactions, certain hotel transactions as well as cruise and car rental reservations. Agency revenues are recognized on a net basis on air transactions

when the reservation is made and secured by a credit card. A cancellation allowance is recognized on these revenues based on historical experience. OTravel.com recognizes agency revenues on hotel reservations, cruise and car rental reservations, either on an accrual basis for payments from a commission clearinghouse or on receipt of commissions from an individual supplier. Revenue from our travel business is included in the fulfillment partner segment, as it is not significant enough to separate out as its own segment.

Auctions business

We operate an online auction service as part of our Website. Our auction tab allows sellers to list items for sale, buyers to bid on items of interest, and users to browse through listed items online. We are not the seller of the items sold on the auction site and we have no control over the pricing of those items. Therefore, for these sales we record only our listing fees and commissions for items sold as revenue. Revenue from our auction business is included in the fulfillment partner segment, as it is not significant enough to segregate as its own segment.

Cost of goods sold

Cost of goods sold consists of the cost of the product, as well as inbound and outbound freight, warehousing and fulfillment costs (including payroll and related expenses), credit card fees, customer service costs and stock-based compensation.

Operating expenses

Sales and marketing expenses consist primarily of advertising, public relations and promotional expenditures, as well as payroll and related expenses for personnel engaged in marketing and selling activities. Advertising expense is the largest component of our sales and marketing expenses and is primarily attributable to expenditures related to online marketing activities and our offline national radio and television advertising. For the three months ended June 30, 2005 and 2006, our advertising expenses totaled approximately $14.1 million and $11.5 million, respectively, representing 97% and 94%, respectively, of sales and marketing expenses for those respective periods. For the six months ended June 30, 2005 and 2006, our advertising expenses totaled approximately $30.6 million and $24.0 million, respectively, representing 98% and 95%, respectively, of sales and marketing expenses for those respective periods.

Technology expenses consist of wages and benefits for technology personnel, rent, utilities, connectivity charges, as well as support and maintenance and depreciation and amortization related to software and computer equipment.

General and administrative expenses consist of wages and benefits for executive, legal, accounting, merchandising and administrative personnel, rent and utilities, travel and entertainment, depreciation and amortization of intangible assets and other general corporate expenses.

We have recorded no provision or benefit for federal and state income taxes as we have incurred net operating losses since inception. We have provided a full valuation allowance on the net deferred tax assets, consisting primarily of net operating loss carryforwards, because of uncertainty regarding their realizability.

Both direct and fulfillment partner revenues are seasonal, with revenues historically being the highest in the fourth quarter, reflecting higher consumer holiday spending. We anticipate this will continue in the foreseeable future.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are as follows:

- revenue recognition;
- estimating valuation allowances and accrued liabilities, specifically, the reserve for returns, the allowance for doubtful accounts and the reserve for obsolete and damaged inventory;
- internal use software;

20

- accounting for income taxes;
- valuation of long-lived and intangible assets and goodwill; and
- stock based compensation and performance share plan.

Revenue recognition. We derive our revenue from four sources: (i) direct revenue, which consists of merchandise sales made to consumers and businesses that are fulfilled from our warehouse; (ii) fulfillment partner revenue, which consists of revenue from the sale of merchandise shipped by fulfillment partners directly to consumers and other businesses, as well as fee revenue collected from the products listed and sold through the auction tab of our Website; and (iii) merchant hotel revenues; and (iv) commission revenue from our auctions and agency travel operations. All sources of revenue are recorded net of returns, coupons redeemed by customers, and other discounts. Revenues from our auction and travel services were not material in the first quarters of 2005 and 2006 and therefore are included in fulfillment partner revenue.

We record revenue from the majority of these sales transactions involving our fulfillment partners (excluding auction and travel products) on a gross basis. Similar to our direct revenue segment, fulfillment partner products are available to both consumers and businesses.

For sales transactions, we comply with the provisions of Staff Accounting Bulletin 104 Revenue Recognition , which states that revenue should be recognized when the following revenue recognition criteria are met: (1) persuasive evidence of an arrangement exists; (2) the product has been shipped or the service provided and the customer takes ownership and assumes the risk of loss; (3) the selling price is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. We generally require payment by credit card at the point of sale. Amounts received prior to when we ship the goods or provide the services to customers are recorded as deferred revenue. In addition, amounts received in advance for gift cards, and marketing royalties related to our co-branded credit card program are recorded as deferred revenue and recognized in the period earned.

Accounting for merchant and agency revenues for our Travel subsidiary. The determination of gross versus net presentation is based principally on the company s consideration of Staff Accounting Bulletin No. 101 Revenue Recognition in Financial Statements and Emerging Issues Task Force Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, including the weighing of the relevant qualitative factors regarding our status as the primary obligor, and the extent of pricing latitude and inventory risk. The method of merchant revenue presentation by the Company does not impact operating profit, net income, or cash flows, but rather revenues and cost of sales.

The principal factor in determining gross versus net presentation was the consideration of who is the primary obligor in the relationship with the customer. Our Travel business provides extensive customer service and support for its customers; however, the supplier hotel is principally liable to its merchant hotel customers in all situations where the customer does not receive the hotel services booked through OTravel.com. In this case, OTravel.com provides customer service support to help resolve issues, even though such customer support could typically involve issues for which OTravel.com is not principally liable.

OTravel.com generates both merchant hotel revenues and agency air, hotel, car and cruise revenues. Merchant hotel revenues are recognized as net revenue at the time of booking since all transactions are billed directly to customers, are nonrefundable and generally non-cancelable, and require no significant post-delivery obligations for OTravel.com. A reserve for charge-backs and cancellations is recorded at the time of the transaction based on historical experience.

Agency revenues are derived from airline ticket transactions, certain hotel transactions as well as cruise and car rental reservations. Agency revenues are recognized on a net basis on air transactions when the reservation is made and secured by a credit card. A cancellation allowance is recognized on these revenues based on historical experience. OTravel.com recognizes agency revenues on hotel reservations, cruise and car rental reservations, either on an accrual basis for payments from a commission clearinghouse or on receipt of commissions from an individual supplier.

Reserve for returns, allowance for doubtful accounts and the reserve for obsolete and damaged inventory. Our management must make estimates of potential future product returns related to current period revenue. Management analyzes historical returns, current economic trends and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns reserve and other allowances in any accounting period. The reserve for returns was $5.6 million and $1.8 million as of December 31, 2005 and June 30, 2006, respectively.

From time to time, we may grant credit to certain of our business customers on normal credit terms. We perform ongoing credit evaluations of our customers financial condition and maintain an allowance for doubtful accounts receivable based upon our historical collection experience and expected collectibility of all accounts receivable. We maintained an allowance for doubtful accounts receivable of $1.2 million and $1.5 million as of December 31, 2005 and June 30, 2006, respectively.

We write down our inventory for estimated obsolescence or damage equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Once established, the original cost of the inventory less the related inventory reserve represents the new cost basis of such products. Reversal of these reserves is recognized only when the related inventory has been sold or scrapped. As of June 30, 2006, our inventory balance was $74.8 million, net of allowance for obsolescence or damaged inventory of $3.4 million. At December 31, 2005, our inventory balance was $93.3 million, net of reserve for obsolescence or damaged inventory of $5.2 million.

Internal-Use Software and Website Development. Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our websites and processes supporting our business. As required by Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, we capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of three years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During the second quarters of 2005 and 2006, we capitalized $2.7 million and $3.9 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of $134,000 and $741,000 for those respective periods. During the six months ended June 30, 2005 and 2006, we capitalized $14.0 million and $12.0 million, respectively, of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of $370,000 and $1.3 million for those respective periods.

Accounting for income taxes. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. As of December 31, 2005 and June 30, 2006, we have recorded a full valuation allowance of $36.6 million and $48.8 million, respectively, against our net deferred tax asset balance due to uncertainties related to our deferred tax assets as a result of our history of operating losses. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to change the valuation allowance, which could materially impact our financial position and results of operations.

Valuation of long-lived and intangible assets and goodwill. Under SFAS 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but must be tested for impairment at least annually. Other long-lived assets must also be evaluated for impairment when management believes that an asset has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the asset that may not be reflected in an asset s current carrying value, thereby possibly requiring an impairment charge in the future. Goodwill totaled $13.2 million as of December 31, 2005 and June 30, 2006. There was no impairment of goodwill or long-lived assets during the three or six months ended June 30, 2005 and 2006.

Stock-based compensation. As of January 1, 2006, we adopted SFAS 123(R), which requires us to measure compensation cost for all outstanding unvested share-based awards at fair value and recognize compensation over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates. We have utilized a Black-Scholes-Merton valuation model to estimate the value of stock options granted to employees. Several of the primary estimates used in measuring stock-based compensation are as follows:

Expected Volatility: The fair value of stock options were valued using a volatility factor based on the Company s historical stock prices.

Expected Term: The Company s expected term represents the period that the Company s stock options are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms and vesting provisions of the stock-based awards.

Expected Dividend: The Company has not paid any dividends and does not anticipate paying dividends in the foreseeable future.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used on the implied yield currently available on U.S. Treasury zero-coupon issues with remaining term equivalent to the expected term of the options.

Estimated Pre-vesting Forfeitures: When estimating forfeitures, the Company considers voluntary and involuntary termination behavior.

Performance Share Plan. In January 2006 the Board and Compensation Committee adopted the Overstock.com Performance Share Plan, and approved grants to executive officers and certain employees of the Company. The Performance Share Plan provides for a three-year period for the measurement of the Company s attainment of the performance goal described in the form of grant, but at the Company s sole option the Company may make a payment of estimated amounts payable to a plan participant after two years.

The performance goal is measured by growth in economic value, as defined in the plan. The amount of payments due to participants under the plan will be a function of the then current market price of a share of the Company s common stock, multiplied by a percentage dependent on the extent to which the performance goal has been attained, which will be between 0% and 200%. If the growth in economic value is 10% compounded annually or less, the percentage will be 0%. If the growth in economic value is 25% compounded annually, the percentage will be 100%. If the growth in economic value is 40% compounded annually or more, the percentage will be 200%. If the percentage growth is between these percentages, the payment percentage will be determined on the basis of straight line interpolation. Amounts payable under the plan will be payable in cash. During interim and annual periods prior to the completion of the three-year measurement period, we must record compensation expense based upon the period-end stock price and estimates regarding the ultimate growth in economic value that is expected to occur. These estimates include assumed future growth rates in revenues, gross margins and other factors. If we were to use different assumptions, the estimated compensation charges could be significantly different.

For the three and six months ended June 30, 2006, the Company recorded $500,000 and $900,000, respectively of compensation expense under the plan. As of June 30, 2006, we had accrued $900,000 in total compensation expense under the plan.

Recent Accounting Pronouncements.

Based on our review of accounting standards released during the quarter ended June 30, 2006, we did not identify any standard requiring adoption that would have a significant impact on our consolidated financial statements for the periods presented.

Results of Operations 2005 compared to 2006

Revenue

Total revenue grew from $150.6 million during the second quarter of 2005, to $160.0 in 2006, representing growth of 6%. During this same period, direct revenue increased from $60.1 million to $68.8 million (14% growth) while fulfillment partner revenue remained relatively flat at $90.6 million and $91.2 million for those respective periods. For the six months ended June 30, 2005 and 2006, total revenue grew 7%, from $316.5 million in 2005 to $340.2 million in 2006. During the same six-month period, direct revenue grew 16%, from $127.9 million in 2005 to $148.5 million in 2006 while fulfillment partner revenue experienced 2% growth, from $188.6 million in 2005 to $191.7 million in 2006.

The 6% total revenue growth we experienced during the second quarter of 2006 and the 7% growth experienced during the first six months of 2006 was much slower than our historical year over year growth rates have been. This was primarily the result of our focus on improving and fine-tuning system issues that we experienced during the last few months of 2005 that caused growth to begin slowing during that same time. Additionally, we believe that this is partially a result of our reducing marketing expenditures (for the first six months of 2006, marketing expenses decreased 19% year over year) while we focus our resources on completing prior year initiatives and improving internal business processes in an effort to enhance the customer experience. We anticipate that this strategy will continue through the third quarter of 2006, and therefore anticipate similar year over year revenue growth rates during these quarters.

Gross Margins

Total Gross Margins Total cost of goods sold increased $9.0 million or 7%, from $127.9 million during the quarter ended June 30, 2005 to $137.0 million during the quarter ended June 30, 2006, resulting in an increase in gross profits of 1% (from $22.7 million to $23.0 million) during the same periods. As a percent of total revenue, cost of goods sold increased from 84.9% to 85.6% for those respective periods, resulting in gross margins of 15.1% and 14.4% for the quarters ended June 30, 2005 and 2006, respectively. For the six months ended June 30, 2005 and

2006, total cost of goods sold was $269.1 million and $292.0 million, respectively, an increase of 9%, resulting in gross margins of 15.0% and 14.2% for those respective periods.

Generally, our overall gross margins fluctuate based on several factors, including our product mix of sales; sales volumes mix by our direct business and fulfillment partners; changes in vendor pricing; lowering prices for customers, including competitive pricing and inventory management decisions within the direct business; warehouse management costs; customer service costs; and our discounted shipping offers. Discounted shipping offers reduce shipping revenue, and therefore reduce our gross margins on retail sales.

Direct Gross Margins Gross profits for our direct business decreased 14% from $8.5 million for the quarter ended June 30, 2005 to $7.3 million recorded during the same period in 2006. Gross profits as a percentage of direct revenue were 14.2% and 10.6% for the quarters ended June 30, 2005 and 2006, respectively. For the six months ended June 30, 2005 and 2006, gross profits for our direct business were $18.1 million and $16.3 million, a decrease of 10%. The lower gross margins experienced by the direct business are primarily the result of lowering prices to our customers in an effort to reduce inventory levels, and we expect continued markdowns to have a similar effect on gross margins through the last half of 2006. To partially offset this, we saw improvement in warehousing and customer service costs in the second quarter, and anticipate additional cost savings as the improved build-out of our Salt Lake City warehouse and our new customer service application both become operational during the third quarter.

Fulfillment Partner Gross Margins Our fulfillment partner business generated gross profits of $14.2 million and $15.7 million for the quarters ended June 30, 2005 and 2006, respectively, an increase of 11%. Gross margins increased from 15.7% during the first quarter of 2005 to 17.2% during the first quarter of 2006. For the six-month periods, our fulfillment partner business generated gross profits of $29.3 million in 2005 and $31.9 million in 2006, representing growth of 9%. Gross margins for those respective periods were 15.6% in 2005 and 16.6% in 2006.

The increase in gross profits in the second quarter for our fulfillment partner operations was largely due to improvements in product costs and customer service costs .

Travel and Auctions Gross Margins - Fulfillment partner gross margins were augmented by the historically higher gross margins from the Travel and Auctions businesses. The gross profits generated by the travel business this year are primarily a result of merchant hotel revenue related to the operations of Ski West, which we acquired on July 1, 2005. Since revenues from sales in both of these businesses are recorded on a net basis, they result in higher gross margins than our shopping business.

Fulfillment costs

Fulfillment costs include warehouse costs, warehouse handling costs (excluding packaging costs), credit card fees and customer service costs, all of which we include as costs in calculating gross margins. We believe that some companies in our industry, including some of our competitors, account for fulfillment costs within operating expenses, and therefore exclude fulfillment costs from gross margins. As a result, our gross margins may not be directly comparable to others in our industry. The following table has been included to provide investors additional information regarding our classification of fulfillment costs and gross margins, thus enabling investors to better compare our gross margins with others in our industry:

(in thousands)	**Three months ended June 30,**				**Six months ended June 30,**			
	2005		**2006**		**2005**		**2006**	
Total revenue	$ 150,638	100 %	$ 159,968	100 %	$ 316,519	100 %	$ 340,174	100 %
Cost of goods sold:								
Product costs, freight costs and other cost of good sold	117,026	78 %	124,061	78 %	246,229	78 %	262,127	77 %
Fulfillment costs	10,916	7 %	12,913	8 %	22,832	7 %	29,891	9 %
Total cost of goods sold	127,942	85 %	136,974	86 %	269,061	85 %	292,018	86 %
Gross profit	$ 22,696	15 %	$ 22,994	14 %	$ 47,458	15 %	$ 48,156	14 %

As displayed in the above table, fulfillment costs during the quarters ended June 30, 2005 and 2006 were $10.9 million and $12.9 million, respectively, or 7% and 8% of total revenue for those respective periods. For the six months ended June 30, 2005 and 2006, fulfillment costs totaled $22.8 million and $29.9 million, respectively, representing 7% and 9% of total revenue for those respective periods. Fulfillment costs as a percentage of sales may vary due to several factors, such as our ability to manage costs at our warehouses, significant changes in the number of units received and fulfilled, the extent we utilize third party fulfillment services and warehouses, and our ability to effectively manage customer service costs and credit card fees.

24

Operating expenses

Sales and marketing. Sales and marketing expenses totaled $14.5 million and $12.2 million (16% decrease) for the quarters ended June 30, 2005 and 2006, respectively. For the quarters ended June 30, 2005 and 2006, sales and marketing expenses equaled 10% and 8%, respectively, of total revenue. For the six months ended June 30, 2005 and 2006, sales and marketing expenses totaled $31.3 million and $25.3 million (19% decrease), representing 10% and 7% of total revenue for those respective periods.

We direct customers to our Websites primarily through a number of targeted online marketing channels, such as sponsored search, affiliate marketing, portal advertising, e-mail campaigns, and other initiatives. We also utilize channels such as nation-wide television, print and radio advertising campaigns. Our marketing expense is variable and is measured as a percentage of overall sales.

We reduced marketing expenditures in the first and second quarters of 2006 to focus our resources on completing prior year initiatives and improving internal business processes. For the six-month periods ending June 30, marketing expenditures decreased 19%, year over year, from $31.3 million in 2005, to $25.3 million in 2006, as we discontinued the least effective marketing efforts in both on-line and television, print and radio campaigns. For the second half of 2006, we intend to continue to spend approximately 10-20% less than in 2005.

While costs associated with our discounted shipping promotions are not included in marketing expense (they are accounted for as a reduction of revenue), we consider discounted shipping promotions as an effective marketing tool, and intend to continue to offer them as we deem appropriate.

Sales and marketing expenses also included stock-based compensation related to the adoption of SFAS 123(R) of $79,000 and $149,000 during the three and six months ended June 30, 2006, respectively.

Technology expenses. Technology expenses increased 147%, from $6.1 million during the quarter ended June 30, 2005 to $15.0 million during same period in 2006. For the six-month periods, technology expenses increased 181% from $10.2 million in 2005 to $28.6 million in 2006, representing 3% and 8% of total revenue for those respective periods.

We incurred a stair-step increase in technology costs during the last nine months of 2005, as we made a significant investment in all of our major systems. As a result, technology expenses are much higher in 2006 than they were in 2005, and we anticipate this to continue through the end of 2006. The increases in expense are related primarily to increased depreciation expense, as well as increases in maintainance and support costs, and increased IT personnel, including consultants. These increased expenses, combined with slowing growth, will result in a significant increase in technology expenses as a percent of sales for the full-year 2006.

Although we plan to continue to invest in technology, we expect overall annual capital expenditures to decrease to approximately $30-$35 million, or half of 2005 levels in 2006. This includes some additional investment in our newly expanded infrastructure, including hardware and software used to enhance performance, reliability and stability of our internal systems and website.

Technology expenses also included stock-based compensation related to the adoption of SFAS 123(R) of $181,000 and $340,000 during the three and six months ended June 30, 2006, respectively.

General and administrative expenses. General and administrative expenses increased 65%, from $7.6 million during the quarter ended June 30, 2005 to $12.5 million during the same quarter in 2006, representing 5% and 8% of total revenue for each of the respective periods. For the six-month periods, general and administrative expenses increased 73%, from $14.9 million in 2005 to $25.8 million in 2006, representing 5% and 8% of total revenue for those respective periods.

The increase in general and administrative expenses in the three and six months ended June 30, 2006 compared to the same periods in 2005 relates to increases in payroll-related expenses, professional fees, merchandising, legal and finance costs. Also in the third quarter of 2005, we relocated our corporate offices to larger facilities, increasing rent expense by approximately $1.0 million quarterly. Slowing growth, combined with these increases in G&A expense, will result in a significant increase in G&A expense as a percent of sales for the full year 2006.

We incurred stock-based compensation within general and administravive expenses of approximately $719,000 and $1.4 million for the three and six months ended June 30, 2006, respectively.

Overall, a much bigger portion of our technology and general and administrative expenses are now non-cash. We estimate that total depreciation and amortization expense will approximate $30.0 million in 2006. Therefore, including stock-based compensation, these non-cash expenses are estimated to be around $35.0 million for the year, compared to approximately $16.0 million of similar non-cash expenses in 2005.

Performance Share Plan. In January 2006, the Board and Compensation Committee adopted the Overstock.com Performance Share Plan and approved grants to our executive officers and certain employees. The Performance Share Plan provides for a three-year period for the measurement of our attainment of the performance goal described in the form of grant, at our sole option we may make a payment of estimated amounts payable to a plan participant after two years.

Approximately $500,000 in compensation expense under the plan has been included in general and administrative expenses for the quarter ended June 30, 2006 and $900,000 has been included during the six months then ended.

Non-operating income (expense)

Interest income, interest expense and other income (expense).

The primary components of our net interest income, interest expense and other income (expense) are the interest derived from the investment of our excess cash in marketable securities offset by interest expense related to the convertible debt, letters of credit, capital leases, and other related fees.

Interest income increased from $896,000 during the quarter ended June 30, 2005 to $2.2 million during the same quarter in 2006 due primarily to a $1.9 million gain on the sale of our foreign notes. For the six months ended June 30, 2005 and 2006, interest income increased from $1.5 million to $2.5 million, respectively.

Under SFAS No. 133, the Foreign Notes were considered to be derivative financial instruments and were marked to market quarterly. Any unrealized gain or loss related to the changes in value of the conditional coupon was recorded in the income statement as a component of interest income or expense. Any unrealized gain or loss related to the changes in the value of the Notes was recorded as a component of other comprehensive income (loss). On April 26, 2006, we sold the Foreign Notes for $49.5 million, resulting in the gain on the bond instrument of $1.9 million. See Note 3 Marketable Securities .

Interest expense is largely related to our convertible notes, capital leases and our line of credit. Interest expense decreased slightly from $1.5 million during the quarter ended June 30, 2005 to $1.3 million during the same period in 2006. For the six month periods, interest expense decreased from $3.0 million to $2.5 million.

Other income for the three and six months ended June 30, 2005 relates to the retirement of $33.0 million of Senior Notes for $27.9 million, which resulted in a recognized gain of $4.2 million.

Income taxes

Income taxes. For the quarters ended June 30, 2005 and 2006, we incurred net operating losses, and consequently paid insignificant amounts of federal, state and foreign income taxes. As of December 31, 2005 and June 30, 2006, we had net operating loss carryforwards of approximately $58.0 million and $96.4 million, respectively, which may be used to offset future taxable income. An additional $21.9 million of net operating losses are limited under Internal Revenue Code Section 382 to $799,000 a year. These net operating loss carryforwards will begin to expire in 2019.

Supplemental Information about Stock-Based Compensation

Periods prior to the adoption of SFAS 123(R)

Prior to January 1, 2006, we accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The intrinsic value method of accounting resulted in compensation expense for stock options to the extent option exercise prices were set below market prices on the date of grant. Also, to the extent stock awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed as an offset to operating expenses.

The following table illustrates the effects on net loss and net loss per share as if we had applied the fair value recognition provisions of SFAS 123 to options granted under our stock-based compensation plans prior to the adoption of SFAS 123(R). For purposes of this pro forma disclosure, the value of the options was estimated using the Black-Scholes-Merton (BSM) option-pricing formula and amortized on a straight-line basis over the respective vesting periods of the awards. Disclosures for the three months ended June 30, 2006 are not presented because stock-based payments were accounted for under SFAS 123(R) s fair value method during this period.

26

	Three months ended June 30, 2005	Six months ended June 30, 2005
Net loss, as reported	$ (1,923)	$ (6,233)
Add: Stock-based employee compensation, as reported	53	73
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,011)	(1,915)
Pro forma net loss SFAS 123 fair value adjusted	$ (2,881)	$ (8,075)
Net loss per common share		
Basic and diluted - as reported	$ (0.10)	$ (0.32)
Basic and diluted - pro forma	$ (0.15)	$ (0.41)

Adoption of SFAS 123(R)

As of January 1, 2006, we adopted SFAS No. 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of stock options is determined using the BSM valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 148, *Accounting for Stock Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure.* Such value is recognized as expense over the service period, net of estimated forfeitures, using the straight-line method under SFAS 123(R).

The adoption of SFAS 123(R) did not result in a cumulative benefit from accounting change, which reflects the net cumulative impact of estimating future forfeitures in the determination of period expense, rather than recording forfeitures when they occur as previously permitted, as we did not have unvested employee stock awards for which compensation expense was recognized prior to adoption of SFAS No. 123(R).

On March 29, 2005, the SEC published Staff Accounting Bulletin (SAB) No. 107, which provides the Staff s views on a variety of matters relating to stock-based payments. SAB 107 requires stock-based compensation be classified in the same expense line items as cash compensation. We have reclassified stock-based compensation from prior periods to correspond to current period presentation within the same operating expense line items as cash compensation paid to employees.

The application of SFAS 123(R) had the following effect on the three and six months ended June 30, 2006 reported amounts relative to amounts that would have been reported using the intrinsic value method under previous accounting (in thousands, except per share amounts):

SFAS 123(R) Adjustments	**Three months ended June 30, 2006**	**Six months ended June 30, 2006**
Operating loss	$ (1,088)	$ (2,046)
Net loss	$ (1,088)	$ (2,046)
Net loss per common share basic and diluted	$ (0.05)	$ (0.10)

Seasonality

Based upon our historical experience, increased revenues typically occur during the fourth quarter because of the holiday retail season. The actual quarterly results for each quarter could differ materially depending upon consumer preferences, availability of product and competition, among other risks and uncertainties. Accordingly, there can be no assurances that seasonal variations will not materially affect our results of operations in the future. The following table reflects our revenues for each of the quarters since 2002 (in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2006	$ 180,206	$ 159,968		
2005	165,881	150,638	$ 169,323	$ 317,980
2004	82,078	87,792	103,444	221,321
2003	29,164	28,833	57,788 *	123,160
2002	12,067	14,380	23,808	41,529

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* Note that total revenue since the third quarter of 2003 reflects the change in our policy in which sales by fulfillment partners are recorded gross instead of net as in prior quarters.

27

Liquidity and Capital Resources

At June 30, 2006, our cash and cash equivalents balance was $45.7 million.

Our operating activities resulted in net cash outflows of $10.1 million and $6.2 million for the quarters ended June 30, 2005 and 2006, respectively. For the six months ended June 30, 2005 and 2006, cash outflows from operating activities were $45.3 million and $78.9 million, respectively. The primary use of cash and cash equivalents during the six months ended June 30, 2006 was to fund our operations, including net losses of $31.6 million (including $16.0 million of net non-cash activity), as well as changes in prepaid expenses, accounts payable and accrued liabilities of $1.2 million, $65.5 million and $23.3 million, respectively. This was offset by the cash provided from a reduction in inventory and prepaid inventory of $24.8 million as well as collections of accounts receivable of $1.9 million. For the six months ended June 30, 2005, cash outflows was a result of funding our net loss of $6.2 million (including $760,000 of net non-cash activity) for the period and changes in inventory, prepaid expenses and accounts payable of $15.0 million, $4.6 million and $24.6 million, respectively. This was offset by the cash provided by changes in prepaid inventory and accrued liabilities of $1.9 million and $2.5 million, respectively.

We have payment terms with our fulfillment partners that extend beyond the amount of time necessary to collect proceeds from our customers. As a result, following our seasonally strong fourth quarter sales, at December 31 of each year, our cash, cash equivalents, marketable securities and accounts payable balances typically reach their highest level (other than as a result of cash flows provided by or used in investing and financing activities). However, our accounts payable balance normally declines during the first three months following year-end, which normally results in a decline in our cash, cash equivalents, and marketable securities balances in the first quarter each year.

Due to the seasonality in our quarterly sales and operating cash flows, we believe the trailing twelve month (TTM) operating cash flow to be a better indication of our true operating cash flow. For the twelve months ending June 30, 2006, the TTM operating cash outflows were $39.8 million versus $8.8 million for the TTM ending June 30, 2005. For the TTM ended June 30, 2006, cash outflows resulted from net losses, combined with changes in accounts receivable, inventories, prepaid expenses, other long-term assets, accounts payable and accrued liabilities of $3.3 million, $13.3 million, $1.5 million, $2.1 million, $4.5 million and $2.3 million, respectively, offset by a decrease in prepaid inventory of $7.2 million.

Investing activities resulted in cash inflows of $55.8 million and $44.2 million for the three months ended June 30, 2005 and 2006, respectively. For the six-month periods, investing activities resulting in cash outflows of $23.3 million in 2005 and cash inflows of $44.7 million in 2006. During the six months ended June 30, 2006, the cash inflows resulted from the sale of marketable securities of $56.8 million, including the sale of our foreign notes of $49.5 million in April, offset by expenditures for property and equipment of $12.2 million. Cash outflows from investing activities for the six months ended June 30, 2005 resulted from investments in marketable securities of $162.0 million and expenditures for property and equipment of $24.3 million, offset by sales of marketable securities of $162.2 million.

Financing activities resulted in cash outflows of $52.0 million for the quarter ended June 30, 2005 and cash inflows of $5.1 million for the quarter ended June 30, 2006. For the six-month periods, financing activities resulted in cash outflows of $98.7 million in 2005 and cash inflows of $23.7 million in 2006. The cash inflows in 2006 primarily are the result of cash received from the sale of common stock for $25.0 million and $1.5 million from the exercise of employee stock options, offset by payments on capital lease obligations of $2.8 million. Cash outflows for financing activities in 2005 were primarily from capital lease payments of $3.1 million and the payments of $27.9 million to retire our convertible senior notes, $24.1 million to purchase our common stock, and $47.5 million to purchase call options to purchase our common stock. These outflows were offset by $3.9 million from the exercise of stock options and warrants.

While we believe that the cash and marketable securities currently on hand, amounts available under our credit facility and expected cash flows from future operations will be sufficient to continue operations for at least the next twelve months, we may require additional financing. However, there can be no assurance that if additional financing is necessary it will be available, or, if available, that such financing can be obtained on satisfactory terms. Failure to generate sufficient revenues, generate profitability or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives. Any projections of future cash needs and cash flows are subject to substantial uncertainty.

Contractual Obligations and Commitments. The following table summarizes our contractual obligations as of June 30, 2006 and the effect such obligations and commitments are expected to have on our liquidity and cash flow in future periods:

	Payments Due by Period (in thousands)				
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 years**
Long-term debt arrangements	$ 77,000	$	$	$	$ 77,000
Interest on convertible senior notes	15,882	2,888	5,775	5,775	1,444
Capital lease obligations	9,699	5,734	3,965		
Operating leases	78,160	12,301	17,873	16.375	31,611
Purchase obligations	29,500	29,500			
Line of credit					
Total contractual cash obligations	$ 210,241	$ 50,423	$ 27,613	$ 22,150	$ 110,055

	Amounts of Commitment Expiration Per Period (in thousands)				
Other Commercial Commitments	**Total Amounts Committed**	**Less than Year 1**	**1-3 Years**	**4-5 Years**	**Over 5 years**
Letters of credit	$ 11,819	$ 11,819	$	$	$
Redeemable common stock	2,398	2,398			
Total commercial commitments	$ 14,217	$ 14,217	$	$	$

We may be subject to additional earn-out payments related to the acquisition of SkiWest (based on a percentage of operating profits for each of the four calendar years beginning with 2006 as follows: 50%, 33.3%, 20%, and 10%, respectively).

3.75% Convertible Senior Notes

In November 2004, we completed an offering of $120.0 million of 3.75% Convertible Senior Notes (the Senior Notes). Interest on the Senior Notes is payable semi-annually on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2011 and are unsecured and rank equally in right of payment with all existing and future unsecured, unsubordinated debt and senior in right of payment to any existing and future subordinated indebtedness. The Senior Notes are convertible at any time prior to maturity into our common stock at the option of the note holders at a conversion price of $76.23 per share (subject to adjustment in certain events, including stock splits, dividends and other distributions and certain repurchases of our stock, as well as certain fundamental changes in the ownership of the Company).

Beginning December 1, 2009, we have the right to redeem the Senior Notes, in whole or in part, for cash at 100% of the principal amount plus accrued and unpaid interest. Upon the occurrence of a fundamental change (including the acquisition of a majority interest in the Company, certain changes in the Company s board of directors or the termination of trading of our stock) meeting certain conditions, holders of the Senior Notes may require us to repurchase for cash all or part of their notes at 100% of the principal amount plus accrued and unpaid interest.

In 2005, under the Share Repurchase Program discussed below, we retired $43.0 million of the Senior Notes for $35.7 million in cash. As a result of the note retirements, we recognized a gain of $6.2 million, net of the associated unamortized discount of $1.2 million for the year ended December 31, 2005. As of June 30, 2006, $77.0 million of Senior Notes and unamortized debt discount of $1.9 million remain outstanding.

Lease and Purchase Obligations

The lease obligations include our obligations under a ten-year lease agreement we entered in December 2004 for approximately 154,000 square feet of office space in Salt Lake City. We took possession of the new office space in July of 2005, and terminated our lease obligations under our previous office lease agreements at the same time. The total lease obligation over the ten-year term of the new lease is $39.6 million, of which approximately $3.5 million will be payable in 2006. In connection with the preparation of the new office space, we have provided a letter of credit for $500,000 to provide funds for the removal of the improvements upon termination of the new sublease and have also agreed to pay approximately $2.0 million for leasehold improvements. We paid for the majority of the leasehold improvements during 2005.

The amount of purchase obligations shown is based on assumptions regarding the legal enforceability against us of purchase orders we had outstanding at June 30, 2006. Under different assumptions regarding our rights to cancel our purchase orders or different assumptions regarding the enforceability of the purchase orders under applicable law, the amount of purchase obligations shown in the table above would be less.

29

Borrowings

$30.0 million Amended Credit Agreement

On October 18, 2005, the Company entered into a sixth amendment to a credit agreement (Amended Credit Agreement) with Wells Fargo Bank, National Association. The Amended Credit Agreement provides a revolving line of credit to the Company of up to $30.0 million which we use primarily to obtain letters of credit to support inventory purchases. Borrowings and outstanding letters of credit under the credit agreement are collateralized by cash balances held at Wells Fargo Bank, National Association. The Amended Credit Agreement expires on December 31, 2007, however, we have an option to renew the Amended Credit Agreement annually. Interest on borrowings is payable monthly and accrued at either (i) 1.35% above LIBOR in effect on the first day of an applicable fixed rate term, or (ii) at a fluctuating rate per annum determined by the bank to be one half a percent (0.50%) above daily LIBOR in effect on each business day a change in daily LIBOR is announced by the bank. Unpaid principal, together with accrued and unpaid interest is due on the maturity date.

The Amended Credit Agreement requires us to comply with certain covenants, including restrictions on mergers, business combinations or transfer of assets. We were in compliance with these covenants at June 30, 2006.

At June 30, 2006, no amounts were outstanding under the Amended Credit Agreement, and letters of credit totaling $11.8 million were issued on our behalf.

$40.0 million WFRF Agreement

On December 12, 2005, we entered into a Loan and Security Agreement (the WFRF Agreement) with Wells Fargo Retail Finance, LLC and related security agreements and other agreements described in the WFRF Agreement.

The WFRF Agreement provides for advances to us and for the issuance of letters of credit for its account of up to an aggregate maximum of $40.0 million. We have the right to increase the aggregate maximum amount available under the facility to up to $50.0 million during the first two years of the facility. The amount actually available to us may be less and may vary from time to time, depending on, among other factors, the amount of our eligible inventory and receivables. Our obligations under the WFRF Agreement and all related agreements are collateralized by all or substantially all of our and our subsidiaries assets. Our obligations under the WFRF Agreement are cross-collateralized with our assets pledged under its $30.0 million credit facility with Wells Fargo Bank, National Association. The term of the WFRF Agreement is three years, expiring on December 12, 2008. The WFRF Agreement contains standard default provisions.

Advances under the WFRF Agreement bear interest at either (a) the rate announced, from time to time, within Wells Fargo Bank, National Association at its principal office in San Francisco as its prime rate or (b) a rate based on LIBOR plus a varying percentage between 1.25% and 1.75%; however, the annual interest rate on advances under the WFRF Agreement will be at least 3.50%. The WFRF Agreement includes affirmative covenants as well as negative covenants that prohibit a variety of actions without the lender s approval, including covenants that limit our ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another person, (d) sell assets, (e) change our name or the name of any of our subsidiaries, (f) make certain changes to our business, (g) optionally prepay, acquire or refinance indebtedness, (h) consign inventory, (i) pay dividends on, or purchase, acquire or redeem shares of, our capital stock, (j) change our method of accounting, (k) make investments, (l) enter into transactions with affiliates, or (m) store any of our inventory or equipment with third parties. We were in compliance with these covenants as of June 30, 2006.

At June 30, 2006, no amounts were outstanding under the WFRF Agreement.

Redeemable Common Stock

The estimated amount of redeemable common stock is based solely on the statutes of limitations of the various states in which stockholders may have rescission rights and may not reflect the actual results. The stock is not redeemable by its terms. We do not have any unconditional purchase obligations, other long-term obligations, guarantees, standby repurchase obligations or other commercial commitments. These rescission rights, if any, expire September 30, 2006.

Share Repurchase Program

During January 2005, our Board of Directors authorized a share repurchase program under which we were authorized to repurchase up to $50.0 million of our common stock through December 31, 2007. On April 26, 2005, the Board of Directors increased the amount of the share repurchase program to $100.0 million. Additionally, on June 14, 2005, the Board of Directors authorized an amendment of our three-year share repurchase program to include the repurchase of our Convertible Senior Notes.

30

Under the repurchase program, we repurchased approximately 665,000 shares of our common stock in open market transactions for $24.1 million during the year ended December 31, 2005. In addition, approximately 1.0 million shares of common stock were acquired as a result of the settlement of $41.1 million of structured stock repurchase transactions during the year ended December 31, 2005. The purchased call options that did not settle in stock settled in cash totaling $7.9 million, which we received in July 2005. We also repurchased convertible senior notes having an aggregate principal amount of $43.0 million. As of June 30, 2006, we have utilized all of the $100.0 million authorized by the board of directors under the share repurchase program.

Shelf Registration

In April 2005, we filed a registration statement with the Securities and Exchange Commission using a shelf registration or continuous offering process. Under this shelf process, we may, from time to time, sell any or all of the securities described in the prospectus in one or more offerings up to a total dollar amount of $500.0 million. On May 1, 2006, we issued approximately $1.042 million shares of common stock for an aggregate price of $25.0 million.

While we believe that the cash and marketable securities currently on hand, amounts available under our credit facility and expected cash flows from future operations will be sufficient to continue operations for at least the next twelve months, we may require additional financing. However, there can be no assurance that if additional financing is necessary it will be available, or, if available, that such financing can be obtained on satisfactory terms. Failure to generate sufficient revenues, generate profitability or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives. Any projections of future cash needs and cash flows are subject to substantial uncertainty.

Government Regulation

All of our services are subject to federal and state consumer protection laws including laws protecting the privacy of consumer non-public information and regulations prohibiting unfair and deceptive trade practices. In particular, under federal and state financial privacy laws and regulations, we must provide notice to consumers of our policies on sharing non-public information with third parties, must provide advance notice of any changes to our policies and, with limited exceptions, must give consumers the right to prevent sharing of their non-public personal information with unaffiliated third parties. Furthermore, the growth and demand for online commerce could result in more stringent consumer protection laws that impose additional compliance burdens on online companies. These consumer protection laws could result in substantial compliance costs and could interfere with the conduct of our business.

In many states, there is currently great uncertainty whether or how existing laws governing issues such as property ownership, sales and other taxes, libel and personal privacy apply to the Internet and commercial online services. These issues may take years to resolve. In addition, new state tax regulations may subject us to additional state sales and income taxes. 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 commercial online services could result in significant additional taxes on our business. These taxes could have an adverse effect on our cash flows and results of operations. Furthermore, there is a possibility that we may be subject to significant fines or other payments for any past failures to comply with these requirements.

Factors that May Affect Future Results

Any investment in our securities involves a high degree of risk. Investors should consider carefully the risks and uncertainties described below, and all other information in this Form 10-Q and in our other filings with the SEC including those we file after we file this Form 10-Q, before deciding whether to purchase or hold our securities. Additional risks and uncertainties not currently known to us or that we currently deem immaterial may also become important factors that may harm our business. The occurrence of any of the following risks could harm our business. The trading price of our securities could decline due to any of these risks and uncertainties, and investors may lose part or all of their investment.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our financial instruments consist of cash and cash equivalents, marketable securities, trade accounts and contracts receivable, accounts payable and long-term obligations. We consider investments in highly-liquid instruments purchased with a remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Our exposure to market risk for changes in interest rates relates primarily to our short-term investments and short-term obligations; thus, fluctuations in interest rates would not have a material impact on the fair value of these securities.

At June 30, 2006, we had $45.7 million in cash and cash equivalents. A hypothetical increase or decrease in interest rates of one hundred basis points would have an estimated impact of approximately $114,000 on our loss for the quarter

31

ended June 30, 2006, or the fair market value or cash flows of these instruments.

At June 30, 2006, we had $77.0 million of convertible senior notes outstanding which bear interest at a fixed rate of 3.75%. In addition, at June 30, 2006, we had $11.8 million in letters of credit outstanding under our credit facilities.

The fair value of the convertible senior notes is sensitive to interest rate changes. Interest rate changes would result in increases or decreases in the fair value of the convertible senior notes, due to differences between market interest rates and rates in effect at the inception of the obligation. Unless we elect to repurchase our convertible senior notes in the open market, changes in the fair value of convertible senior notes have no impact on our cash flows or consolidated financial statements. The estimated fair value of our 3.75% Convertible Senior Notes as of June 30, 2006 and December 31, 2005 was $54.7 million.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information relating to the Company and its consolidated subsidiaries required to be disclosed in the Company s periodic filings under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported in a timely manner in accordance with the requirements of the Exchange Act, and that such information is accumulated and communicated to management, including the Company s Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer), as appropriate, to allow timely decisions regarding required disclosure. The Company carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer), of the effectiveness of the design and operation of these disclosure controls and procedures, as such term is defined in Exchange Act Rule 13a-15(e), as of June 30, 2006. Based on this evaluation, the Chief Executive Officer (principal executive officer) and Senior Vice President, Finance (principal financial officer) each concluded that the Company s disclosure controls and procedures were effective as of June 30, 2006.

Changes in Internal Control Over Financial Reporting

There have been no changes in the Company s internal control over financial reporting that occurred during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we receive claims of and become subject to consumer protection, employment, intellectual property and other commercial litigation related to the conduct of our business. Such litigation could be costly and time consuming and could divert our management and key personnel from our business operations. The uncertainty of litigation increases these risks. In connection with such litigation, we may be subject to significant damages or equitable remedies relating to the operation of our business and the sale of products on our websites. Any such litigation may materially harm our business, prospects, results of operations, financial condition and cash flows. However, we do not currently believe that any of our outstanding litigation will have a material impact on our financial statements.

In October 2003, Tiffany (NJ) Inc. and Tiffany and Company filed a complaint against us in the United States District Court for the Southern District of New York alleging that we have distributed counterfeit and otherwise unauthorized Tiffany product in violation of federal copyright and trademark law and related state laws. In January and February 2005, Tiffany (NJ) Inc. and Tiffany and Company filed five additional complaints against us in the United States District Court for the Southern District of New York alleging that we have distributed counterfeit and otherwise unauthorized Tiffany product in violation of federal copyright and trademark law and related state laws. We reached a confidential agreement that settled all of these cases and all of the cases were dismissed on July 14, 2006.

In September 2004, we received a letter from BTG International Inc. claiming that certain of our business practices and online marketing information technology systems infringe patents owned by BTG. On September 14, 2004, without engaging in any meaningful discussion or negotiation with us, BTG filed a complaint in the United States District Court of Delaware alleging that certain of our business practices and online marketing information technology systems infringe a single patent owned by BTG. We reached a confidential agreement that settled the case and it was dismissed on July 12, 2006.

In December 2003, we received a letter from Furnace Brook claiming that certain of our business practices and our on-line ordering system infringe a single patent owned by Furnace Brook. After diligent efforts to show that we do not infringe the patent and Furnace Brook s continual demands that we enter into licensing arrangements with respect to the asserted patent, on August 12, 2005, we filed a complaint in the United States District Court of Utah, Central Division, seeking declaratory judgment that we do not infringe any valid claim of the Furnace Brook patent. Furnace Brook filed a motion to dismiss our complaint for lack of personal jurisdiction over Furnace Brook in Utah. On October 31, 2005, the United States District Court of Utah, Central Division, issued a decision to dismiss our complaint for lack of personal jurisdiction over Furnace Brook. On December 14, 2005, we filed an appeal of the Utah decision with the United States Court of Appeals for the Federal Circuit. The United States Court of Appeals for the Federal Circuit has scheduled a oral argument on that appeal for August 7, 2006. On August 18, 2005, shortly after we filed the complaint in Utah, Furnace Brook filed a complaint in the United States District Court for the Southern District of New York, alleging that certain of our business practices and our on-line ordering system infringe a single patent owned by Furnace Brook. On September 9, 2005 we filed an answer denying the material allegations in Furnance Brook s claims. Although we have filed an answer and believe we have defenses to the allegations and intend to pursue them vigorously, we do not have sufficient information to assess the probability of success or the amount of potential damages.

On August 11, 2005, along with a shareholder plaintiff, we filed a complaint against Gradient Analytics, Inc.; Rocker Partners, LP; Rocker Management, LLC; Rocker Offshore Management Company, Inc. and their respective principals. We, along with a second shareholder plaintiff, filed the complaint in the Superior Court of California, County of Marin. On October 12, 2005, we filed an amended complaint against the same entities alleging libel, intentional interference with prospective economic advantage and violations of California s unfair business practices act. On March 7, 2006, the court denied the defendants demurrers to and motions to strike the amended complaint. The defendants have each filed a motion to appeal the court s decision and we have responded; the court has ruled that this appeal stays discovery in the case. We intend to pursue this action vigorously.

On May 9, 2006 we received a notice of an investigation and subpoena from the Securities and Exchange Commission, Salt Lake City District Office. The subpoena requests a broad range of documents, including, among other documents, all documents relating to our accounting policies, our targets, projections or estimates related to financial performance, our recent restatement of its financial statements, the filing of our complaint against Gradient Analytics, Inc., the development and implementation of certain new technology systems and disclosures of progress and problems with those systems, communications with and regarding investment analysts, communications regarding shareholders who did not receive our proxy statement in April 2006, communications with certain shareholders, and communications regarding short selling, naked short selling, purchases and sales of our stock, obtaining paper certificates, and stock loan or borrow of our shares. We have responded to much of the subpoena and anticipate a complete response by mid-August.

ITEM 1A. RISK FACTORS

These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially. *For a detailed discussion of these risks and uncertainties please see Item 1A Risk Factors and the description of risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2005. These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.*

Risks Relating to Overstock

We have a history of significant losses. If we do not achieve profitability, our financial condition and our stock price could suffer.

We have a history of losses and we may continue to incur operating and net losses for the foreseeable future. We incurred net losses attributable to common shares of $2.0 million and $15.8 million for the three months ended June 30, 2005 and 2006, respectively, and $ 6.3 million and $31.7 million for the six months ended June 30, 2005 and 2006, respectively. As of December 31, 2005 and June 30, 2006, our accumulated deficit was $96.8 million and $128.5 million, respectively. We will need to generate significant revenues to achieve profitability, and we may not be able to do so. Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis in the future. If our revenues grow more slowly than we anticipate, or if our operating expenses exceed our expectations, our financial results would be harmed.

We will continue to incur significant operating expenses and capital expenditures as we:

- enhance our distribution and order fulfillment capabilities;
- further improve our order processing systems and capabilities;
- develop enhanced technologies and features;

33

- expand our customer service capabilities to better serve our customers needs;
- expand our product offerings, including our auctions site, our travel site and our custom design jewelry site;
- rent additional warehouse and office space;
- increase our general and administrative functions to support our operations; and
- maintain or increase our sales, branding and marketing activities, including maintaining existing or entering into new online marketing arrangements, and continuing or increasing our national television and radio branding campaigns.

Because we will incur many of these expenses before we receive any revenues from our efforts, our losses may be greater than the losses we would incur if we developed our business more slowly. Further, we base our expenses in large part on our operating plans and future revenue projections. Many of our expenses are fixed in the short term, and we may not be able to quickly reduce spending if our revenues are lower than we project. Therefore, any significant shortfall in revenues would likely harm our business, prospects, operating results and financial condition. In addition, we may find that these efforts are more expensive than we currently anticipate which would further increase our losses. Also, the timing of these expenses may contribute to fluctuations in our quarterly operating results.

If we fail to accurately forecast our expenses and revenues, our business, operating results and financial condition may suffer and the price of our securities may decline.

Our limited operating history and the rapidly evolving nature of our industry make forecasting operating results difficult. We have recently completed several large, complex and expensive infrastructure upgrades in order to increase our ability to handle larger volumes of sales and to develop or increase our ability to perform a variety of analytical procedures relating to our business, and we are continuing the work to upgrade and further expand these and other components of our infrastructure. We have experienced difficulties with the implementation of various aspects to the upgrades of our infrastructure, and have incurred increased expenses as a result of these difficulties. As a result of these expenditures, our ability to quickly reduce spending if our revenues are lower than we project is limited. Therefore, any significant shortfall in the revenues for which we have built and are continuing to build our infrastructure would likely harm our business, prospects, operating results and financial condition and cause our results of operation to fall below the expectations of public market analysts and investors. If this occurs, the price of our securities may decline.

We depend on our relationships with third party fulfillment partners for a large portion of the products that we offer for sale on our Websites. If we fail to maintain these relationships, our business will suffer.

At June 30, 2006, we had fulfillment partner relationships with approximately 478 third parties whose products we offer for sale on our Websites. These products accounted for approximately 80% of the non-BMVG products available. We do not have any long-term agreements with any of these third parties. Our agreements with third parties are terminable at will by either party immediately upon notice. In general, we agree to offer the third parties products on our Websites and these third parties agree to provide us with information about their products, honor our customer service policies and ship the products directly to the customer. If we do not maintain our existing or build new relationships with third parties on acceptable commercial terms, we may not be able to offer a broad selection of merchandise, and customers may refuse to shop at our Websites. In addition, manufacturers may decide not to offer particular products for sale on the Internet. If we are unable to maintain our existing or build new fulfillment partner relationships or if other product manufacturers refuse to allow their products to be sold via the Internet, our business and prospects would suffer severely.

We are partially dependent on third parties to fulfill a number of our fulfillment, distribution and other retail functions. If such parties are unwilling or unable to continue providing these services, our business could be seriously harmed.

In our fulfillment partner business, although we handle returned merchandise, we continue to rely on third parties to conduct a number of other traditional retail operations with respect to their respective products that we offer for sale on our Websites, including maintaining inventory, preparing merchandise for shipment to individual customers and timely distribution of purchased merchandise. We have no effective means to ensure that these third parties will continue to perform these services to our satisfaction or on commercially reasonable terms. In addition, because we do not take possession of these third parties products, we are unable to fulfill these traditional retail operations ourselves. Our customers could become dissatisfied and cancel their orders or decline to make future purchases if these third parties are unable to deliver products on a timely basis. If our customers become dissatisfied with the services provided by these third parties, our reputation and the Overstock.com brand could suffer.

We rely on our relationships with manufacturers, retailers and other suppliers to obtain sufficient quantities of quality merchandise on acceptable terms. If we fail to maintain our supplier relationships on acceptable terms, our sales and profitability could suffer.

To date, we have not entered into contracts with manufacturers or liquidation wholesalers that guarantee the availability of merchandise for a set duration. Our contracts or arrangements with suppliers do not provide for the continuation of particular pricing practices and may be terminated by either party at any time. Our current suppliers may not continue to sell their excess inventory to us on current terms or at all, and we may not be able to establish new supply relationships. For example, it is difficult for us to maintain high levels of product quality and selection because none of the manufacturers, suppliers and liquidation wholesalers from whom we purchase products on a purchase order by purchase order basis have a continuing obligation to provide us with merchandise at historical levels or at all. In most cases, our relationships with our suppliers do not restrict the suppliers from selling their respective excess inventory to other traditional or online merchandise liquidators, which could in turn limit the selection of products available on our Websites. If we are unable to develop and maintain relationships with suppliers that will allow us to obtain sufficient quantities of merchandise on acceptable commercial terms, such inability could harm our business, prospects, results of operation and financial condition.

We depend upon third-party delivery services to deliver our products to our customers on a timely and consistent basis. Deterioration in our relationship with any one of these third parties could decrease our ability to track shipments, cause shipment delays, and increase our shipping costs and the number of damaged products.

We rely upon multiple third parties for the shipment of our products. Because we do not have a written long-term agreement with any of these third parties, we cannot be sure that these relationships will continue on terms favorable to us, if at all. Unexpected increases in shipping costs or delivery times, particularly during the holiday season, could harm our business, prospects, financial condition and results of operations. If our relationships with these third parties are terminated or impaired or if these third parties are unable to deliver products for us, whether through labor shortage, slow down or stoppage, deteriorating financial or business condition, responses to terrorist attacks or for any other reason, we would be required to use alternative carriers for the shipment of products to our customers. In addition, conditions such as adverse weather can prevent any carriers from performing their delivery services, which can have an adverse effect on our customers satisfaction with us. In any of these circumstances, we may be unable to engage alternative carriers on a timely basis, upon terms favorable to us, or at all. Changing carriers would likely have a negative effect on our business, prospects, operating results and financial condition. Potential adverse consequences include:

- reduced visibility of order status and package tracking;
- delays in order processing and product delivery;
- increased cost of delivery, resulting in reduced gross margins; and
- reduced shipment quality, which may result in damaged products and customer dissatisfaction.

A significant number of merchandise returns could harm our business, financial condition and results of operations.

We allow our customers to return products and, beginning July 1, 2003, we started accepting returns of products sold through our fulfillment partners. We modify our policies relating to returns from time to time, and any policies intended to reduce the number of product returns may result in customer dissatisfaction and fewer return customers. If merchandise returns are significant, our business, prospects, financial condition and results of operations could be harmed.

If the products that we offer on our Websites do not reflect our customers tastes and preferences, our sales and profit margins would decrease.

Our success depends in part on our ability to offer products that reflect consumers tastes and preferences. Consumers tastes are subject to frequent, significant and sometimes unpredictable changes. Because the products that we sell typically consist of manufacturers and retailers excess inventory, we have limited control over the specific products that we are able to offer for sale. If our merchandise fails to satisfy customers tastes or respond to changes in customer preferences, our sales could suffer and we could be required to mark down unsold inventory which would depress our profit margins. In addition, any failure to offer products in line with customers preferences could allow our competitors to gain market share. This could have an adverse effect on our business, prospects, results of operations and financial condition.

We face risks relating to our inventory.

We directly purchase some of the merchandise that we sell on our Websites. We assume the inventory damage, theft and

35

obsolescence risks, as well as price erosion risks for products that we purchase directly. These risks are especially significant because some of the merchandise we sell on our Websites are characterized by rapid technological change, obsolescence and price erosion (for example, computer hardware, software and consumer electronics), and because we sometimes make large purchases of particular types of inventory. In addition, we often do not receive warranties on the merchandise we purchase. Further, beginning July 1, 2003, we started accepting returns of products sold through our fulfillment partners, and we have the risk of reselling the returned products.

In the recent past, we have recorded charges for obsolete inventory and have had to sell certain merchandise at a discount or loss. It is impossible to determine with certainty whether an item will sell for more than the price we pay for it. Because we rely heavily on purchased inventory, our success will depend on our ability to liquidate our inventory rapidly, the ability of our buying staff to purchase inventory at attractive prices relative to its resale value and our ability to manage customer returns and the shrinkage resulting from theft, loss and misrecording of inventory. If we are unsuccessful in any of these areas, we may be forced to sell our inventory at a discount or loss.

We have grown quickly and if we fail to manage our growth, our business will suffer.

We have rapidly and significantly expanded our operations, and anticipate that further significant expansion will be required to address potential growth in our customer base and market opportunities. This expansion has placed, and is expected to continue to place, a significant strain on our management, operational and financial resources. Some of our officers have no prior senior management experience at public companies. Our new employees include a number of key managerial, technical and operations personnel, and we expect to add additional key personnel in the future. To manage the expected growth of our operations and personnel, we will be required to improve existing and implement new transaction-processing, operational and financial systems, procedures and controls, and to expand, train and manage our already growing employee base. If we are unable to manage growth effectively, our business, prospects, financial condition and results of operations will be harmed.

The loss of key personnel or any inability to attract and retain additional personnel could affect our ability to successfully grow our business.

Our performance is substantially dependent on the continued services and on the performance of our senior management and other key personnel, particularly Patrick M. Byrne, our Chief Executive Officer. Our performance also depends on our ability to retain and motivate other officers and key employees. The loss of the services of any of our executive officers or other key employees for any unforeseen reason, including without limitation, illness or call to military service, could harm our business, prospects, financial condition and results of operations. We do not have employment agreements with any of our key personnel and we do not maintain key person life insurance policies. Our future success also depends on our ability to identify, attract, hire, train, retain and motivate other highly-skilled technical, managerial, editorial, merchandising, marketing and customer service personnel. Competition for such personnel is intense, and we cannot assure you that we will be able to successfully attract, assimilate or retain sufficiently qualified personnel. Our failure to retain and attract the necessary technical, managerial, editorial, merchandising, marketing and customer service personnel could harm our revenues, business, prospects, financial condition and results of operations.

We may be unable to manage expansion into new business areas which could harm our business operations and reputation.

Our long-term strategic plan involves expansion of our operations to offer additional types of products and services. We cannot assure you that our efforts to expand our business in this manner will succeed. Because we were unable to generate significant traffic for our former B2B site, in the third quarter of 2004, we merged the B2B site into our main website, and opened our Wholesale bulk purchase program. Our failure to succeed in this market or other markets or other product or service offerings may harm our business, prospects, financial condition and results of operation. We cannot assure you that we will be able to expand our operations in a cost-effective or timely manner or that our efforts to expand will be successful. Furthermore, any new business or Website we launch that is not favorably received by consumers could damage our reputation or the Overstock.com brand. We may expand the number of categories of products we carry on our Websites and these and any other expansions of our operations would also require significant additional expenses and development and would strain our management, financial and operational resources. The lack of market acceptance of such efforts or our inability to generate satisfactory revenues from such expanded services or products to offset their cost could harm our business, prospects, financial condition and results of operations.

We may expand our international business, causing our business to become increasingly susceptible to numerous international business risks and challenges that could affect our profitability.

We have begun to expand into international markets, and in the future we may do so more aggressively. International sales and transactions are subject to inherent risks and challenges that could adversely affect our profitability, including:

- the need to develop new supplier and manufacturer relationships;
- the need to comply with additional laws and regulations to the extent applicable;
- unexpected changes in international regulatory requirements and tariffs;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- potential adverse tax consequences;
- price controls or other restrictions on foreign currency; and
- difficulties in obtaining export and import licenses.

To the extent we generate international sales and transactions in the future, any negative impact on our international operations could negatively impact our business. In particular, gains and losses on the conversion of foreign payments into United States dollars may contribute to fluctuations in our results of operations and fluctuating exchange rates could cause reduced gross revenues and/or gross margins from non-dollar-denominated international sales.

In order to obtain future revenue growth and achieve and sustain profitability we will have to attract customers on cost-effective terms.

Our success depends on our ability to attract customers on cost-effective terms. We have relationships with online services, search engines, directories and other Websites and e-commerce businesses to provide content, advertising banners and other links that direct customers to our Websites. We rely on these relationships as significant sources of traffic to our Websites and to generate new customers. If we are unable to develop or maintain these relationships on acceptable terms, our ability to attract new customers and our financial condition could be harmed. In addition, certain of our online marketing agreements may require us to pay upfront fees and make other payments prior to the realization of the sales, if any, associated with those payments. Accordingly, if these agreements or similar agreements that we may enter into in the future fail to produce the sales that we anticipate, our results of operations will be adversely affected. We cannot assure you that we will be able to increase our revenues, if at all, in a cost-effective manner. We periodically conduct national television and radio branding and advertising campaigns. Such campaigns are expensive and may not result in the cost effective acquisition of customers.

Further, many of the parties with which we may have online-advertising arrangements could provide advertising services for other online or traditional retailers and merchandise liquidators. As a result, these parties may be reluctant to enter into or maintain relationships with us. Failure to achieve sufficient traffic or generate sufficient revenue from purchases originating from third parties may result in termination of these relationships by these third parties. Without these relationships, our revenues, business, prospects, financial condition and results of operations could suffer.

We may not be able to compete successfully against existing or future competitors.