BLUEFLY INC
Form 10-Q
May 11, 2006

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

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2006

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

Commission File Number: 001-14498

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [X]

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

As of May 9, 2006, the issuer had outstanding 21,426,154 shares of Common Stock, $.01 par value.

BLUEFLY, INC.

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Part I - FINANCIAL INFORMATION
ITEM 1. - FINANCIAL STATEMENTS

BLUEFLY, INC.

CONDENSED BALANCE SHEETS (Unaudited)

ASSETS

Current assets
Cash and cash equivalents
Inventories, net
Accounts receivable, net of allowance for doubtful accounts
Prepaid inventory
Prepaid expenses
Other current assets

Total current assets

Property and equipment, net

Other assets

Total assets

Current liabilities
Accounts payable
Allowance for sales returns
Accrued expenses and other current liabilities
Deferred revenue

Total current liabilities

Notes payable to related party shareholders
Long-term interest payable to related party shareholders
Long-term obligations under capital lease

Total liabilities

Commitments and contingencies

Shareholders' equity
Series A Preferred stock - $.01 par value; 500,000 shares authorized, 460,000 issued and outstanding as of March 31, 2006 and December 31, 2005, respectively (liquidation preferen $9.2 million plus accrued dividends of $6.2 million and $5.9 million as of March 31, 2006 and December 31, 2005, respectively)

Series B Preferred stock - $.01 par value; 9,000,000 shares authorized, 8,889,414 shares issu and outstanding as of March 31, 2006 and December 31, 2005, respectively (liquidation preference: $30 million plus accrued dividends of $10.1 million and $9.5 million as of Mar 31, 2006 and December 31, 2005, respectively)

Series C Preferred stock - $.01 par value; 3,500 shares authorized and 1,000 shares issued an outstanding as of March 31, 2006 and December 31, 2005, respectively (liquidation preferen $1 million plus accrued dividends of $311,000 and $286,000 as of March 31, 2006 and Decemb 31, 2005, respectively)

Series D Preferred stock - $.01 par value; 7,150 shares authorized 5,386.745 and 6,313.43 iss and outstanding as of March 31, 2006 and December 31, 2005 (liquidation preference: $5.4 million plus accrued dividends of $2.2 million and $6.3 million plus $2.4 million as of March 31, 2006 and December 31, 2005, respectively)

Series E Preferred stock - $.01 par value; 1,000 shares authorized, issued and outstanding as March 31, 2006 and December 31, 2005, respectively (liquidation preference: $1.0 million p accrued dividends of $384,000 and $347,000 as of March 31, 2006 and December 31, 2005, respectively)

Series F Preferred stock - $.01 par value; 7,000 shares authorized, 3,857.143 and 5,279.714 issued and outstanding as of March 31, 2006 and December 31, 2005, respectively (liquidati preference: $3.9 million plus accrued dividends of $207,000 and $5.3 million plus $192,000 of March 31, 2006 and December 31, 2005, respectively)

Common stock - $.01 par value; 92,000,000 shares authorized and 21,426,154 and 19,059,166 sha issued and outstanding as of March 31, 2006 and December 31, 2005, respectively
Additional paid-in capital
Accumulated deficit

Total shareholders' equity

Total liabilities and shareholders' equity

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

BLUEFLY, INC.
CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Net sales	$ 16,876,000	$ 13,502,000
Cost of sales	10,037,000	8,617,000
Gross profit	6,839,000	4,885,000
Selling, marketing and fulfillment expenses	7,464,000	4,035,000
General and administrative expenses	2,427,000	1,586,000
Total operating expenses	9,891,000	5,621,000
Operating loss	(3,052,000)	(736,000)
Interest and other income	45,000	40,000
Interest and other expense	(257,000)	(197,000)
Net loss	$ (3,264,000)	$ (893,000)
Preferred stock dividends	(1,231,000)	(1,115,000)
Net loss available to common shareholders	$ (4,495,000)	$ (2,008,000)
Basic and diluted loss per common share	$ (0.22)	$ (0.13)
Weighted average common shares outstanding (basic and diluted)	20,367,508	15,299,040

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

BLUEFLY, INC.
CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	THREE MON MARCH
	2006
Cash flows from operating activities	
Net loss	$ (3,264,000)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	353,000
Stock options expense	612,000
Warrant issued to consultant	67,000
Provisions for returns	(629,000)
Allowance for doubtful accounts	43,000
Reserve for inventory obsolescence	240,000
Non-cash expense related to warrant issued to supplier	92,000
Changes in operating assets and liabilities:	
(Increase) decrease in	
Inventories	(4,787,000)
Accounts receivable	(1,274,000)
Prepaid inventory	326,000
Prepaid expenses	634,000
Other current assets	34,000
Increase (decrease) in	
Accounts payable	2,063,000
Accrued expenses and other current liabilities	(186,000)
Interest payable to related party shareholders	149,000
Deferred revenue	672,000
Net cash used in operating activities	(4,855,000)
Cash flows from investing activities	
Purchase of property and equipment	(110,000)
Net cash used in investing activities	(110,000)
Cash flows from financing activities	
Net proceeds from exercise of stock options	--
Payments of capital lease obligation	(14,000)
Net cash used in financing activities	(14,000)
Net decrease in cash and cash equivalents	(4,979,000)
Cash and cash equivalents - beginning of period	9,408,000
Cash and cash equivalents - end of period	$ 4,429,000
Supplemental schedule of non-cash investing and financing activities:	
Cash paid for interest	$ 49,000
Warrant issued to consultant	$ 67,000

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

BLUEFLY, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS - Unaudited
MARCH 31, 2006

NOTE 1 - BASIS OF PRESENTATION

The accompanying financial statements include the accounts of Bluefly, Inc. (the "Company"). The financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting mainly of normal recurring accruals) considered necessary for a fair statement have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year due to seasonal and other factors. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company's Form 10-K for the year ended December 31, 2005. On January 1, 2006 we adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R) "Share Based Payment".

The Company has sustained net losses and negative cash flows from operations since the formation of Bluefly.com. The Company's ability to meet its obligations in the ordinary course of business is dependent on its ability to establish profitable operations and/or raise additional financing through public or private debt or equity financing, or other sources to fund operations. The Company believes that its current funds, together with working capital, and its availability under its existing Credit Facility, will be sufficient to enable it to meet its planned expenditures through December 31, 2006. The Company is exploring possible additional equity financing opportunities to maximize the growth of its business or for use if anticipated operating results are not achieved. If such financings are not available on terms acceptable to the Company, and/or the Company does not achieve its sales plan, future operations will need to be modified, scaled back or discontinued.

During 2005, the Company dissolved its wholly owned subsidiary. This subsidiary had no operations.

NOTE 2 - THE COMPANY

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

NOTE 3 - NOTES PAYABLE TO RELATED PARTY SHAREHOLDERS

In February 2006, the Company extended the maturity dates on the Convertible Promissory Notes issued in July and October 2003 (the "Notes") to affiliates of Soros Private Equity Partners, LLC (collectively, "Soros") that collectively own a majority of the Company's capital stock. The maturity dates of the Notes were each extended for one year, from May 1, 2006 to May 1, 2007.

NOTE 4 - FINANCING AGREEMENT

The Company has a three year revolving credit facility (the "Credit Facility") with Wells Fargo Retail Finance, LLC ("Wells Fargo"). Under the terms of the Credit Facility, Wells Fargo provides the Company with a revolving credit facility and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on substantially all of the Company's assets, as well as a $2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. The maximum availability is currently $7,500,000 ($6,650,000 after giving effect to a required $850,000 availability reserve), but can be increased to $12,500,000 at the Company's request, subject to certain conditions. As of March 31, 2006, total availability under the Credit Facility, after giving effect to the required $850,000 availability reserve, was approximately $6,650,000, of which $2,821,000 was committed, leaving approximately $3,829,000 available for further borrowings.

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

pays Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open. For the three months ended March 31, 2006, the Company incurred approximately $48,000 in connection with these fees.

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

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

NOTE 5 - LOSS PER SHARE

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

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

Security	March 31, 2006	Exercise Prices	March 31, 2005	Exercise Price
Options	8,117,316	$0.69 - $16.47	9,211,885	$0.69 - $16.4
Warrants	1,945,893	$0.78 - $3.96	1,704,945	$0.78 - $9.0
Preferred Stock	42,683,619(1)		43,323,430(1)	
Convertible Notes(2)	--		--	

(1) Excludes dividends on preferred stock, which are payable in cash or common stock, at the Company's option, upon conversion, redemption or liquidation.

(2) Excludes debt issue in connection with the July 2003 financing and the October 2003 financing, which is convertible into equity securities of the Company sold in any subsequent round of financing, at the holders option, at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing. Until such financing occurs, such debt is not convertible into Common Stock.

NOTE 6 - STOCK BASED COMPENSATION

The Company's Board of Directors has adopted three stock option plans, one in April 2005, one in July 2000 and the other in May 1997 (collectively the "Plans"). The Plans were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company, and are similar in nature. Options are granted in terms not to exceed ten years and become exercisable as specified when the option is granted. Vesting terms of the options range from immediately to a ratable vesting period of four years. The Plans have an

aggregate of 15,700,000 shares authorized for issuance. As of March 31, 2006, the Company has reserved an aggregate of 52,746,828 shares of Common Stock for the conversion of Preferred Stock and the exercise of Stock Options and Warrants.

Before January 1, 2006, the Company accounted for stock-based compensation under the recognition and measurement principles of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations. The Company did not recognize compensation expense related to stock options granted to employees and directors where the exercise price was at or above fair value at the date of grant. Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," established accounting and disclosure requirements using a fair-value-based

method of accounting for stock-based employee compensation plans. As permitted by SFAS No. 123, the Company elected to continue to apply the intrinsic-value-based method of APB No. 25 described above, and adopted only the disclosure requirements of SFAS No. 123, as amended by SFAS No. 148, "Accounting For Stock-Based Compensation - Transition and Disclosure."

On January 1, 2006, the start of the first quarter of fiscal 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)") which requires that the costs resulting from all share-based payment transactions be recognized in the financial statements at their fair values. The Company adopted SFAS No. 123(R) using the modified prospective application method under which the provisions of SFAS No. 123(R) apply to new awards and to awards modified, repurchased, or cancelled after the adoption date. Additionally, compensation cost for the portion of the awards for which the requisite service has not been rendered that are outstanding as of the adoption date is recognized in the Statement of Operations over the remaining service period after the adoption date based on the award's original estimate of fair value. Results for prior periods have not been restated. Total share-based compensation expense recorded in the Statement of Operations for the three months ended March 31, 2006 is $612,000.

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 No. 107 requires stock-based compensation be classified in the same expense line items as cash compensation. The application of SFAS No. 123(R) had the following effect on Q1 2006 reported amounts relative to amounts that would have been reported using the intrinsic value method under previous accounting:

As a result of adopting SFAS No. 123(R), the Company's operating loss and net loss for the three months ended March 31, 2006 was $612,000 higher, than if it had continued to account for share-based compensation under APB No. 25. Basic and diluted loss per share for the three months ended March 31, 2006 would have been $0.03 per share lower if the Company had not adopted SFAS No.123(R). There was no effect on the Company's cash flows.

The following table illustrates the effect on net income and net income per common share applicable to common stockholders for the three months ended March 31, 2005, as if the Company had applied the fair value recognition provisions for stock-based employee compensation of SFAS No. 123, as amended. For purposes of the pro forma presentation, option forfeitures are accounted for as they occurred and no amounts of compensation expense have been capitalized into inventory or other assets, but instead were considered as period expenses (in thousands, except per share data):

		THREE MONTHS ENDED MARCH 31, 2005
Net loss, as reported	$	(893,000)
Deduct: total stock based compensation expense determined under fair value based methods for all awards		(712,000)
Add: Stock-based employee compensation Expense included in net loss		16,000
Pro forma net loss applicable to common shareholders		(1,589,000)
Net Loss per share applicable to common shareholders		
Basic and diluted, as reported	$	(0.13)
Basic and diluted, pro forma	$	(0.18)

BLUEFLY, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS - Unaudited
MARCH 31, 2006

The fair value of options granted is estimated on the date of grant using a Black-Scholes option pricing model. Expected volatilities are calculated based on the historical volatility of the Company's stock. Management monitors share option exercise and employee termination patterns to estimate forfeiture rates within the valuation model. The expected holding period of options represents the period of time that options granted are expected to be outstanding. The risk-free interest rate for periods within the expected life of the option is based on the interest rate of U.S. Treasury note in effect on the date of the grant. The Company had previously recorded expense in accordance with APB No. 25 for certain options issued to its CEO and President that were issued below market. Prior to the adoption of FAS 123(R), the Company recognized actual forfeitures when they occurred but has not recorded a cumulative effect adjustment to record estimated forfeitures related to these below market options as the balance was immaterial.

The table below presents the assumptions used to calculate the fair value of options granted during the three months ended March 31, 2006 and 2005, respectively.

	THREE MONTHS ENDED MARCH 31, 2006	THREE MONTHS ENDED MARCH 31, 2005
Expected holding period (years)	6.0	6.0
Risk-free interest rate	4.79%	4.42%
Dividend yield	0.00%	0.00%
Volatility	109%	136%

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

	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Balance at December 31, 2005	8,038,528	$ 1.97
Options granted	120,000	$ 1.12
Options canceled	(41,212)	$ 1.67
Options exercised	-	$ 0.00
Balance at March 31, 2006	8,117,316	$ 1.96
Eligible for exercise at December 31, 2005	4,969,929	$ 2.15
Eligible for exercise at March 31, 2006	5,479,669	$ 2.10

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BLUEFLY, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS - Unaudited
MARCH 31, 2006

The stock options are exercisable in different periods through 2014. Additional information with respect to the outstanding options as of March 31, 2006, is as follows:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING				OPTIONS EXERCISAB	
	VESTED	UNVESTED	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS EXERCISABLE	WE A EX
$0.00 - $1.66	3,506,899	1,568,860	7.6 Years	$ 1.23	3,506,899	$
$1.66 - $3.32	1,655,490	1,020,667	7.3 Years	$ 2.32	1,655,490	$
$3.32 - $4.98	52,880	48,120	7.9 Years	$ 3.92	52,880	$
$4.98 - $6.64	22,250	-	2.7 Years	$ 5.11	22,250	$
$6.64 - $9.96	52,750	-	3.4 Years	$ 9.17	52,750	$
$9.96 - $11.62	104,250	-	3.7 Years	$ 11.20	104,250	$
$11.62 - $14.94	6,250	-	3.7 Years	$ 14.04	6,250	$
$14.94 - $16.60	78,900	-	2.8 Years	$ 15.13	78,900	$
$0.69 - $16.60	5,479,669	2,637,647	7.4 Years	$ 1.96	5,479,669	$

The total fair value of the 509,896 shares that vested during the quarter was $785,000. The weighted average fair value of the options granted during the quarter was $0.98. At March 31, 2006, the aggregate intrinsic value of the fully vested options was $378,000 and the weighted average remaining contractual life of the options was 6.6 years. The Company has not capitalized any compensation cost, or modified any of its stock option grants during the first quarter of 2006. No options were exercised during the quarter and no cash was used to settle equity instruments granted under the Plans during the first quarter of 2006.

As of March 31, 2006, the total compensation cost related to non-vested awards not yet recognized was $3.8 million. Total compensation cost is expected to be recognized over 2 years on a weighted average basis.

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

OVERVIEW

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home furnishings at discounts of up to 75% off of retail value. We launched our Web site in September 1998. Over the past four years, our sales have grown at a compounded annual growth rate of more than 21.9%, while our gross margin percentage has increased from 22.5% in the first quarter of 2003 to 40.5% in the first quarter of 2006.

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

Based on our improved merchandise strategy and recent customer research, we believe that there is an opportunity to accelerate the growth of our business while continuing to provide our customers with the great values that they have become accustomed to. In an effort to take advantage of this opportunity, we raised $7 million of equity financing in June 2005 and used approximately $3.2 million of the proceeds to launch a national advertising campaign. We are

continuing to use the proceeds to fund the advertising campaign for the first half of 2006. This campaign launched in September 2005, and during the first quarter for 2006 we spent approximately $2.9 million in connection with this campaign.

In addition, we secured a new $7.5 million credit facility with Wells Fargo Retail Finance, LLC ("Wells Fargo") in July 2005. This facility is primarily being used to help us obtain the proper merchandising mix to support the anticipated growth in demand from our national advertising campaign.

Our net sales increased by 25% to $16,876,000 for the three months ended March 31, 2006 from $13,502,000 for the three months ended March 31, 2005. Our gross margin increased to 40.5% in 2006 from 36.2% in 2005, 34.0% in 2004 and 22.5% in 2003. Our gross profit increased by 40% to $6,839,000 for the three months ended March 31, 2006 from $4,885,000 for the three months ended March 31, 2005. This growth in gross profit was driven by the increase in net sales, and by the increase in gross margins. Our operating loss increased by almost 315%, to $3,052,000 in 2006, from $736,000 in 2005. This was primarily a result of the increased marketing spend in the first quarter 2006 (approximately $2.9 million higher in first quarter 2006 than first quarter 2005) and the inclusion of approximately $612,000 of stock option expenses as a result of the adoption of SFAS No. 123(R).

We increased our spending in marketing (excluding staff related costs) by 405% to $3,648,000 for the first quarter of 2006, from $723,000 for the first quarter 2005. A large portion of the increased marketing expense was a result of the costs associated with our national advertising campaign, which was launched in September 2005. In general, we intend to market our business more aggressively than we have in previous years. This more aggressive growth strategy will cause our marketing expense as a percentage of revenue to increase in the short-term; however, we believe that it is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead and marketing on a customer's first order.

On January 1, 2006, we adopted SFAS No. 123(R), which requires expensing of stock options. As a result, we recorded total share-based compensation expenses of $612,000 for the three months ended March 31, 2006. Results for prior periods have not been restated due to the adoption based on the modified prospective approach. Had they been restated, additional share-based compensation expenses of $696,000 would have been recorded for the three months ended March 31, 2005.

Our reserve for returns and credit card chargebacks increased to 38.1% of gross sales for the first quarter 2006 compared to 36.3% in 2005. The increase was primarily caused by an increase in average order size as well as a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

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

At March 31, 2006, we had an accumulated deficit of $103,211,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site and building our infrastructure, as well as non cash beneficial conversion charges resulting from decreases in the conversion price of our Preferred Stock. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. Therefore, we may continue to incur substantial operating losses. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

CRITICAL ACCOUNTING POLICIES

Management Estimates

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

Revenue Recognition

We recognize revenue in accordance with Staff Accounting Bulletin ("SAB") No. 104 "Revenue Recognition". Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes. Revenue is recognized when all the following criteria are met:

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

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

Provision for Returns and Doubtful Accounts

We generally permit returns for any reason within 90 days of the sale. Accordingly, we establish a reserve for estimated future returns and bad debt at

the time of shipment based primarily on historical data. We perform credit card authorizations and check the verification of our customers prior to shipment of merchandise. However, our future return and bad debt rates could differ from historical patterns, and, to the extent that these rates increase significantly, it could have a material adverse effect on our business, prospects, cash flows, financial condition and results of operations.

Stock-Based Compensation

As of January 1, 2006, we adopted SFAS No. 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 a cumulative adjustment in the period estimates are revised. We consider historical experience when estimating expected forfeitures. Actual results may differ substantially from these estimates.

Inventory Valuation

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

Deferred Tax Valuation Allowance

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

RESULTS OF OPERATIONS

FOR THE THREE MONTHS ENDED MARCH 31, 2006 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2005

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

	2006		2005	
		As a % of Net Sales		As Ne
Net sales	$ 16,876	100.0%	$ 13,502	
Cost of sales	10,037	59.5%	8,617	

Gross profit	6,839	40.5%	4,885
Selling, marketing and fulfillment expenses	7,464	44.2%	4,035
General and administrative expenses	2,427	14.4%	1,586
Total operating expenses	9,891	58.6%	5,621
Operating loss	(3,052)	(18.1)%	(736)
Interest (expense) and other income, net	(212)	(1.3)%	(157)
Net loss	(3,264)	(19.4)%	(893)

We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the three months ended March 31st, as indicated below:

	2006	2005	2004
Average Order Size (including shipping & handling)	$ 243.92	$ 200.06	$ 189.56
New Customers Added during the Period	38,688	36,765	33,335

Net sales: Gross sales for the three months ended March 31, 2006 increased by over 28% to $27,245,000, from $21,211,000 for the three months ended March 31, 2005. For the three months ended March 31, 2006, we recorded a provision for returns and credit card chargebacks and other discounts of $10,369,000, or approximately 38.1% of gross sales. For the three months ended March 31, 2005, the provision for returns and credit card chargebacks and other discounts was $7,709,000, or approximately 36.3% of gross sales. The increase in this provision as a percentage of gross sales resulted from an increase in the return rate. The increase was primarily caused by an increase in average order size as well as a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the three months ended March 31, 2006 were $16,876,000. This represents an increase of approximately 25% compared to the three months ended March 31, 2005, in which net sales totaled $13,502,000. The growth in net sales resulted from both an increase in the number of new customers acquired (approximately 5% higher compared to first quarter 2005) and an increase in average order size (approximately 22% higher compared to the first quarter 2005). For the three months ended March 31, 2006 revenue from shipping and handling (which is included in net sales) remained relatively unchanged. Beginning in the fourth quarter of 2005 we outsourced our international shipments to a third-party provider and therefore both our average cost and average revenue per international shipment is down, which on a blended rate has decreased our shipping and handling revenue per order.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the three months ended March 31, 2006 totaled $10,037,000 resulting in gross margin of approximately 40.5%. Cost of sales for the three months ended March 31, 2005 totaled $8,617,000, resulting in

gross margin of 36.2%. Gross profit increased by 40%, to $6,839,000 for the three months ended March 31, 2006

compared to $4,885,000 for the three months ended March 31, 2005. The growth in gross margin was primarily the result of increased product margins, which was driven by a merchandising strategy that focused on negotiating better prices with vendors as well as selling more in-season product. In season merchandise has more value to our customers and therefore demands higher margins.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 85% in the first three months of 2006 compared to the first three months of 2005. Selling, marketing and fulfillment expenses were comprised of the following:

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005	Percentage Difference increase (decrease)
Marketing	$ 4,031,000	$ 894,000	350.9%
Operating	1,750,000	1,704,000	2.7%
Technology	971,000	895,000	8.5%
E-Commerce	712,000	542,000	31.4%
	$ 7,464,000	$ 4,035,000	85.0%

As a percentage of net sales, our selling, marketing and fulfillment expenses increased to 44.2% for the three months ended March 31, 2006 from 29.9% in the three months ended March 31, 2005. This increase was primarily related to the increase in advertising spending from our advertising campaign and the recording of stock option expenses as a result of our adoption of SFAS No. 123(R).

Marketing expenses include expenses related to paid search, online and print advertising, fees to marketing affiliates, direct mail campaigns as well as staff related costs. Marketing expenses increased by a higher percentage than our percentage increase in revenue because we focused more of our marketing initiatives on our national advertising campaign. Of the $3.1 million incremental marketing costs in the first quarter 2006 compared to 2005, approximately $2.9 million related to the national advertising campaign.

While this more aggressive growth strategy will cause our marketing expense as a percentage of revenue to increase in the short-term, we believe that it is a prudent investment in our business given that our improved margin structure and average order size have historically resulted in a relatively high positive contribution to overhead on a customer's first order.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in the first three months of 2006 by approximately 3% compared to the first three months of 2005 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees). These increases were partially offset by a decrease in credit card fees attributed to a refund from one of our credit card processors. Costs associated with our temporary clearance store decreased compared to the prior

year, as this store is operated and staffed more efficiently than in the previous year and we pay less rent for our New Jersey location.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the three months ended March 31, 2006, technology expenses increased by approximately 9% compared to the three months ended March 31, 2005. This increase resulted from an increase in salary related expenses, including the expensing of employee stock options in the current year, as well as an increase in software support. This increase was offset slightly by a decrease in depreciation and web hosting expense.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web site design. For the three months ended March 31, 2006, e-commerce expenses increased by approximately 31% as compared to the three months ended March 31, 2005, primarily due to an increase in salary related expenses as well as an increase in expenses associated with photo shoots and the result of recording employee stock option expenses in the current period.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the three months ended March 31, 2006 increased by approximately 53% to $2,427,000 as compared to $1,586,000 for the three months ended March 31, 2005. The increase in general and administrative expenses was primarily the result of the recording of $481,000 of expense related to employee stock options in the current period, increased consulting and professional fees of $81,000, increased public company expenses of $90,000 and increased depreciation expense of $101,000. In addition, the Company incurred approximately $90,000 in real estate taxes in the first quarter 2006.

As a percentage of net sales, general and administrative expenses for the first quarter of 2006 increased to approximately 14.4% from 11.7%.

Loss from operations: Operating loss increased by over 315% in the first three months of 2006 to $3,052,000 from $736,000 in the first three months of 2005 as the increase in net sales and gross margin were more than offset by the incremental marketing expenses and the recording of stock option expenses as a result of the adoption of SFAS No. 123(R).

Interest and other income: Other income for the three months ended March 31, 2006 increased to $45,000 from $40,000 for the three months ended March 31, 2005. These amounts relate primarily to interest income earned on our cash balances.

Interest and other expense: Interest expense for the three months ended March 31, 2006 totaled $257,000, compared to $197,000 for the three months ended March 31, 2005. Interest expense relates to fees paid in connection with our Loan Facility, as well as interest expense on the Convertible Notes.

LIQUIDITY AND CAPITAL RESOURCES

General

At March 31, 2006, we had approximately $4.4 million in the form of cash and cash equivalents. Working capital at March 31, 2006 and 2005 was $15.7 million

and $11.5 million, respectively and at December 31, 2005 was $17.9 million (the March 2005 amount excludes the approximately $1.26 million of restricted cash that we regained access to upon refinancing our previous credit facility). In addition, as of March 31, 2006, we had approximately $2.8 million committed under the Credit Facility, leaving approximately $3.8 million of availability, compared to availability of $900,000 under our previous credit facility at March 31, 2005.

In February 2006, Soros agreed to extend the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, subject to interim extensions, were each further extended for one year, from May 1, 2006 to May 1, 2007.

We fund our operations through cash on hand, operating cash flow, as well as the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance on these financial measures would have a negative impact on our liquidity. Total availability under the Credit Facility is based primarily upon our inventory levels. In addition, both availability under the Credit Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Wells Fargo to provide credit support under the Credit Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and financial press and elsewhere as to our financial strength. Accordingly, negative perceptions as to our financial strength could have a negative impact on our liquidity. In addition, newer vendors generally do not provide us with payment terms that are as favorable as those we get from existing relationships and, in some instances, new vendors may require prepayments. We have increased our prepayments in order to open up new relationships and gain access to inventory that was not previously available to us, as well as in connection with our advertising campaign, as in some circumstances we need to pay in advance of production. As of March 31, 2006, we had approximately $159,000 of prepaid inventory on our balance sheet.

In addition, our inventory levels as of March 31, 2006 were approximately $7.8 million higher than at March 31, 2005. The increase in inventory generally reflects a ramp up in connection with our sales growth as well as opportunistic buying of fresh

inventory that has not previously been available to us. However, the increased inventory level could adversely affect our flexibility in taking advantage of other buying opportunities that may become available in the near term.

We believe that our current funds, together with operating cash flow, and availability under our existing Credit Facility will be sufficient to enable us to meet our planned expenditures through at least December 31, 2006. The Company is exploring possible equity financing opportunities to maximize the growth of our business or for use if anticipated operating results are not achieved. If such financings are not available on terms acceptable to us, and/or we do not achieve our sales plan, future operations may need to be modified, scaled back or discontinued.

Credit Facility

In July 2005, we entered into a new three year revolving credit facility with Wells Fargo Retail Finance, LLC. Pursuant to the Credit Facility, Wells Fargo provides the Company with a revolving loan and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of the Company's assets, as well as a $2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. The maximum availability is currently $7,500,000, but can be increased to $12,500,000 at the Company's request, subject to certain conditions. As of March 31, 2006, total availability under the Credit Facility, after giving effect to the required $850,000 availability reserve, was approximately $6,650,000 of which $2,821,000 was committed, leaving approximately $3,829,000 available for further borrowings.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75%. We also pay a monthly commitment fee on the unused portion of the facility (i.e., $7,500,000 less the amount of loans outstanding) equal to 0.35%. We also pay Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain specified percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open.

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

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

Commitments and Long Term Obligations

As of March 31, 2006, we had the following commitments and long term obligations:

	Total	Less than 1 year	1-3 years
Marketing and Advertising	$ 277,000	277,000	
Purchase Orders	$ 5,799,000	5,799,000	

Operating Leases	$ 1,845,000	564,000	1,210,0
Capital Leases	$ 53,000	40,000	13,0
Employment Contracts	$ 2,822,000	1,395,000	1,427,0
Notes payable to shareholders, including interest payable	$ 5,366,000	--	5,366,0
Grand total	$ 16,162,000	8,075,000	8,016,0

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

Off Balance Sheet Arrangements

Certain warrants issued in conjunction with our preferred stock financing are equity linked derivatives and accordingly represent an off balance sheet arrangement. Each of these warrants meet the scope exception in paragraph 11(a) of FAS 133 and are accordingly not accounted for as derivatives for purposes of FAS 133, but instead included as a component of equity.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES.

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

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

This report may include statements that constitute "forward-looking" statements, usually containing the words "believe", "project", "expect", or similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to

differ materially from the forward-looking statements. The risks and uncertainties are detailed from time to time in reports filed by us with the Securities and Exchange Commission, including Forms 8-A, 8-K, 10-Q, and 10-K. These risks and uncertainties include, but are not limited to, the following: our history of losses and anticipated future losses; need for additional capital and potential inability to raise such capital; the risk of default by us under the Credit Facility and the consequences that might arise from us having granted a lien on substantially all of our assets under that agreement; potential dilution arising from future equity financings, including potential dilution as a result of the anti-dilution provisions contained in our Preferred Stock and Convertible Notes; risks associated with Soros owning a majority of our stock; the potential failure to forecast revenues and/or to make adjustments to our operating plans necessary as a result of any failure to forecast accurately; unexpected changes in fashion trends; the success of our advertising campaign; cyclical variations in the apparel and e-commerce markets; risks of litigation for sale of unauthentic or damaged goods and litigation risks related to sales in foreign countries; the dependence on third parties and certain relationships for certain services, including our dependence on U.P.S. (and the risks of a mail slowdown due to terrorist activity) and our dependence on our third-party web hosting, fulfillment and customer service centers; online commerce security risks; risks related to brand owners' efforts to limit our ability to purchase products indirectly; management of potential growth; the competitive nature of our business and the potential for competitors with greater resources to enter the business; the availability of merchandise; the need to further establish brand name recognition; risks associated with our ability to handle increased traffic and/or continued improvements to our Web site; rising return rates; dependence upon executive personnel; the successful hiring and retaining of new personnel; risks associated with expanding our operations; risks associated with potential infringement of other's intellectual property; the potential inability to protect our intellectual property; government regulation and legal

uncertainties; uncertainties relating to the imposition of sales tax on Internet sales; and risks associated with the agreements with Soros with respect to a change of control and the liquidation preference of the Preferred Stock owned by Soros.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

ITEM 6. EXHIBITS

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

EXHIBIT NUMBER	DESCRIPTION
31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a)

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

BLUEFLY, INC.
MARCH 31, 2006

SIGNATURES

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

BLUEFLY, INC.

By: /s/ Melissa Payner-Gregor

Melissa Payner-Gregor
Chief Executive Officer

By: /s/ Patrick C. Barry

Patrick C. Barry
Chief Financial Officer

May 11, 2006